# Defence Industrial Participation: The South African Experience[1]

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## Introduction

South Africa is presently involved in one of the most controversial arms deals involving offsets. The degree of coverage, of transparency and of debate is unprecedented and has provided important and disturbing insights into the workings of the international arms trade. This makes it an important case study for research on the economics of offset

The story started in September 1999 the South African cabinet approved a R29,9 billion arms acquisition programme for the South African National Defence Force's (SANDF).[2] To justify this decision to purchase from foreign suppliers and to win public support for the arms deal, the South African government stressed the potential positive effects of the proposed industrial participation (IP) offers (otherwise know as offsets) on investment, job creation and growth in the local-defence related industry and the national economy. At the time of approving the programme, they stated that the foreign suppliers had made IP offers worth R104 billion which would result in the creation of more than 65 000 jobs over a period of 7 years.[3] Since then the deal has been mired in controversy and has seen considerable debate and public scrutiny, to an extent unrivalled in any other country.

This chapter consider this experience, providing the specific context and details of the deal, before reviewing the claims and counterclaims. The next section provides some historical background that explains the very unusual nature and development of the South African arms industry, followed by a section that outlines the offsets policy and the arms procurement package that has led to the present controversies. Then an attempt is made to evaluate the general impact of the arms deal, before considering its more specific costs and benefits in the next section. The important political fallout of the deal is then outlined, before the final section draws some conclusions.

## South Africa's Defence-Related Industry and Offsets

From the 1960s until the beginning of the transition to democracy in 1990, South Africa maintained a high and increasing military burden in support of the apartheid state. In 1972 growing external and internal opposition to apartheid, the independence of Angola and Mozambique in 1974, and the involvement of South Africa in their civil wars, led to large increases in military spending, with military burden[4] peaked in 1977 at just under 5% of GDP. This reflected the purchase of large amounts of imported weapons prior to the imposition of the mandatory UN arms embargo in 1977 and the implementation of a "Total Strategy" to combat the perceived "Total Onslaught" of communist expansionism in Southern Africa. Given the demand for weaponry to maintain internal and external security and in anticipation of international sanctions, the apartheid regime invested heavily in the creation of a domestic defence industry. Domestic procurement expenditures increased six-

[2] The original programme and list of preferred suppliers was approved by cabinet in November 1998. The revised programme, approved by cabinet in September 1999 was divided into two tranches: the first tranche, costing R21,3 billion, will include 3 submarines and 4 corvettes from Germany, 12 jet trainers from Britain, 9 light fighters from Britain and Sweden, and 30 light utility helicopters from Italy. The second tranche, costing an additional R8,6 billion will include 12 jet trainers from Britain and 19 light fighters from Britain and Sweden. The 4 maritime helicopters from Britain, and the balance of 10 light utility helicopters from Italy are excluded from the revised programme.

[3] "Economic and Fiscal Impacts of the Procurements", Press Release, Government Communication and Information Service, 15 September 1999.

[4] Military spending as a share of GDP

fold. This transformed the manufacturing economy, with its dependence on arms production increasing over five-fold, to 2.6 percent, between 1972 and 1979 . This led to the creation of a military industrial complex (MIC) centred around the state owned arms producer Armscor with private firms acting as subcontractors. Sophisticated products such as jet fighters, attack helicopters, armoured vehicles, communications systems, guidance systems, mobile artillery pieces, and reconnaissance drones had to be domestically produced or illegally sourced, so industrial policy favoured the arms industry and encouraging import substituting high technology production. This led to South Africa developing a level of technical sophistication and independence that was unique to arms production in developing countries. Resources flooded into the arms and other strategic industries creating growth, but leading to inefficient allocation of investment and inefficiencies that led to serious economic problems in the 1980s (Batchelor, Dunne and Saal, 2000).

Between 1989 and 1997, South Africa's defence expenditure declined by more than 50% in real terms, mainly due to the withdrawal of South African troops from Angola and Namibia, South Africa's political transition and the downsizing of the South African military establishment (Batchelor, Dunne and Lamb, 2002). This had a dramatic effect on the country's defence-related industry, which downsized and restructured. The public sector was restructured and commercialised, with the production side of Armscor split off to form Denel in 1992. Armscor's procurement policies, including more transparent and competitive procurement from both local and foreign suppliers, fundamentally altered the 'cosy' relationship that was evident between the public and private sector industry during the apartheid era. Since 1994, the African National Congress (ANC) led government's commitment to black empowerment has resulted in a number of empowerment deals and equity partnerships between (largely white) private sector defence companies.

In response to the continuing decline in demand, local defence firms have pursued a number of supply-side adjustment strategies. Denel and the three largest private sector defence groups (Reunert, Grintek and Altech) experienced financial problems, but all the private firms have reduced their dependence on their defence business to less than 20% of turnover and offset the declines in domestic defence with significant increases in non-defence work and export orders.

This downsizing and restructuring of the local defence industry took place in a policy vacuum, with the government adopting a 'hands-off' approach to defence industrial adjustment as military spending declined. However defence industry policy was back of the agenda from 1996, with facilitation of national review of South Africa's defence needs and capabilities, which is commonly referred to as the Defence Review. The Defence Review set out four options for a force design for the South African National Defence Force (SANDF). The option that emphasised reduced manpower and increased capital intensity[5] was approved by Cabinet and Parliament in April 1998. This option recognised that there was no short or medium term military threat to South Africa, and that the defence budget would remain restricted for an extensive period of time. Ideally this option envisaged the acquisition of a wide range of major defence equipment, and these purchases would require Cabinet and Parliamentary approval (Department of Defence, 1998:34-48).

[5] It proposed reversing the trend of increasing personnel and operating expenditure to allow for increased capital expenditure by cutting personnel levels in the SANDF from 100 000 to around 70 000 by 2000/01. The proposed rationalisation process in the SANDF would reduce the share of personnel expenditure to 40% and operating expenditure to 30% of the total defence budget, thereby allowing capital expenditure to increase to 30% of the budget, a level last achieved in 1993/94 (Defence Review, 1998)..

Armscor subsequently issued requests for tenders to foreign suppliers to meet the SANDF's new equipment requirements, with all potential foreign suppliers being notified of the government's new policy on offsets, and requested to submit proposals with their tenders.

The approval of a large procurement order with foreign suppliers was an explicit recognition that a general defence industry could not be supported, but that companies may prosper in particular niche markets. It was the offsets, ie Defence Industrial Participation (DIP) policy, that was to facilitate this. Developed from the general National Industrial Participation (NIP) policy, which came into being in 1996[6], the DIP policy aimed to retain and create jobs, abilities and capabilities; allow a sustainable defence industrial capacity, with strategic logistic support capabilities; to promote value-added arms exports; to promote like-for-like technology transfer and joint ventures; to maintain skilled indigenous manufacturing capabilities. It included a requirement that there should be no increase in price as a result of IP[7]; that it must represent new business; that it must be economically and operationally sustainable; that it must result directly from the purchase contract[8]; and the fulfilment of any IP obligation was to lie solely with the seller. Allowable IP projects and activities were investments; joint ventures; sub-contracting; licensed production; R&D collaboration; export promotion and supply partnerships[9].

For NIP policy related to DoD purchases, the value threshold was set at US$10 million (or equivalent), with DIP obligation split 50:50 between national (i.e. non-defence) and defence priorities. All DIP activities were to be managed by Armscor and all non-military portions of the projects managed by the DTI in accordance with the provisions of NIP policy. The discharge period for all DIP obligations was 7 years. A penalty of 10% to be levied by Armscor, with the approval of the DoD, on the unfulfilled portion of DIP obligations for contracts worth US$10 million or more[10].

In September 1999 the cabinet approved a revised version of the SANDF`s arms acquisition package and made information about the costs of each of the components of the acquisition programme together with some details about the foreign suppliers' NIP proposals public, as shown in Table 1. Parliament's approval was not sought as members of the Executive argued

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[6] Offsets or 'Industrial Participation' (IP) as it is officially referred to in South Africa, became mandatory for all government purchases in September 1996. NIP effects all government and parastatal purchases or lease contracts (goods, equipment and services) with an imported content equal to or exceeding US$ 10 million (or the equivalent thereof) are subject to an Industrial Participation Obligation. The IP obligation must equal or exceed 30% of the value of the imported content of the purchase or lease and must be fulfilled within 7 years from the effective date of the IP agreement. The prospective foreign seller/supplier has to submit and implement business projects, which would generate IP credits equalling or exceeding the 30% IP obligation. A 5% performance guarantee is required prior to the IP contract being awarded. The mission of the NIP policy is *'to leverage economic benefits and support the development of South African industry by effectively utilising the instrument of government procurement'*. The stated objectives of NIP policy are: sustainable economic growth; the establishment of new trading partners; the generation of inward foreign investment; increasing exports of 'value added' goods and services; R&D collaboration; job creation; human resource development; technology transfer; and the creation of economic advantages for previously disadvantaged communities.

[7] this is very difficult to police as there is no fixed price

[8] The exception is the Strategic Partnership Agreement (SPA), which involves a long-term agreement between government and supplier and is not linked to a single tender.

[9] In evaluating IP proposals a credit system is used which also allows the accumulation of credits.

[10] Armscor levies a penalty up to 30% on the unfulfilled portion of DIP obligations for contracts worth between US$2 million and US$10 million.

that such approval of the Defence Review equated with approval of an acquisition programme.

**Table 1. SANDF Acquisition Programme**

| Programme | Number of Units | Supplier | Cost |
|---|---|---|---|
| ***Tranche 1:*** | | | |
| Corvettes | 4 | Germany | R6,917m |
| Submarines | 3 | Germany | R5,354m |
| Light Utility Helicopters | 30 | Italy | R1,949m |
| Jet Trainer/Light Fighter | 12/9 | Britain/Sweden | R7,110m |
| **Total: Tranche 1** | | | **R21,330m** |
| ***Tranche 2:*** | | | |
| Jet Trainer/Light Fighter | 12/19 | Britain/Sweden | R8,662m |
| **Total: Tranche 1& 2** | | | **R29,992m** |

Source: Department of Defence, Defence Acquisition Package, 18 November 1998
Note: * Total value of IP activities as a percentage of purchase cost

The total direct cost of the acquisition programme was estimated at R29,9 billion (in 1999 prices and exchange rates) to be paid out over a period of at least 8 to 14 years, with equipment to be delivered between 2000 and 2008. The total IP commitments (DIP and NIP) were valued at R104 billion, although the actual economic benefits deriving from these commitments is expected to amount to almost R70 billion over a period of 11 years[11]. These were in 3 categories:

i) direct offsets: defence related offsets (about 20% of the total) including direct purchases from the local defence industry; technology transfers and export orders for local defence firms;

ii) indirect offsets: counter-purchase by the foreign defence suppliers of non-defence goods and services from South Africa (about 45%);

iii) inward investment in South Africa's defence and non-defence industries by the foreign defence suppliers and other companies associated with the suppliers (about 35% )[12].

It was estimated that at least R14,5 billion of the total IP offers of R104 billion would be spent directly in the local defence-related industry with the balance of R89,5 billion to be spent on non-defence activities, including indirect offsets and inward investment. Each of the arms acquisition programmes carried a 5% penalty clause for non-delivery on NIP and DIP projects and activities.

In terms of NIP, table 2 below provides a breakdown of the total commitment per consortium.

**Table 2: NIP Commitment and Delivery per Company**

| Company | Total IP Commitment |
|---|---|
| BAE-Saab | $7,2 billion |
| Ferrostaal | 2,85 billion Euros |
| More to be added | |

[11] GCIS, 15 September 1999.
[12] GCIS, 15 September 1999.

The official original cost of the arms deal was R30 billion. This has jumped to R53 billion. Unofficial estimates are much higher. The original total NIP estimate was R110 billion, but is now estimated to be R140 billion, largely the result of through currency fluctuation and other problems……

**The impact of the Arms Deal**

As mentioned earlier the procurement of arms from foreign suppliers rather than from the domestic industry did cast a shadow over its future. This might not have concerned the government as a body of literature that suggests that military spending is unproductive and can either have no significant effect, or a negative effect on economic growth in developing countries, with the negative economic effects exacerbated by investment in domestic arms production (Brauer, 1991; Dunne, 1996, Dunne, 1995). Indeed, Batchelor and Willett (1998) argued that 'the expansion of the domestic arms industry (during the 1970s and 1980s) distorted the trajectory of the country's industrial development (and) imposed a number of long-term economic costs on the economy. The absorption of scarce resources (capital, labour and foreign exchange) and the crowding out of non-military public and private investment and of non-military R&D contributed to the underdevelopment, declining productivity and poor international competitiveness of the civilian economy.' Despite the marked downsizing and restructuring, the SA defence-related industry remains highly capital, skill, import and research intensive, with very limited linkages to the civilian economy. However, rather than allowing the industry to continue in decline, Government policy became the maintenance of a local defence industry through the use of offsets.

This policy has seen local companies benefiting through the direct DIP activities, by foreign suppliers buying sub-systems, and components from the domestic defence industry, either under license or in collaboration with the foreign suppliers. The impact has been to provide orders to domestic companies and opportunities for companies to develop niches in the international market through links with the foreign companies. Denel and private companies have been drawn into the international circuits of defence production both in terms of indirect DIP and direct DIP. For instance, Denel has been contracted to build the tail section of the RAF's fleet of Hawk fighter trainers[13]. It is also building landing gear fuselage sections for the Gripen jet fighter, and rudders and ailerons for other BAE Systems aeroplanes. These are not overly high-tech manufacturing operations and may reflect some watering down of the technological path/expertise of Denel. Other DIP contracts are of a nature that is obliging contractors to rethink their niche business eg. Tellumat/Eloptro and their form. There is an increasing participation of European defence groupings and investors in the South African industry, at prime contractor and sub-contractor levels. This participation is part of ongoing restructuring and expansion of international defence groups such as EADS and Thales. Local divisions can influence government-to-government dealings to the benefit of the parent company and local subsidiary.

The value of purchases from the local defence industry are dependent on their competitiveness (in terms of price, quantity and delivery) and capabilities, and whether the foreign suppliers are confident that local inputs can be successfully integrated into their weapons systems. The market-driven processes of downsizing and restructuring led to a loss

[13] Business Day 26/10/00

of capabilities, including skilled human resources, in many sectors and sub-sectors of the local industry.

South Africa's maritime and naval shipbuilding industry, which is concentrated in Durban and Cape Town, has downsized quite dramatically in recent years with the attendant loss of valuable capabilities and skills. The country's only naval shipyard, Dorbyl Marine, closed down in the early 1990s because of poor trading conditions. The industry thus lacks the capacity to design and manufacture major naval ships including submarines, although a few companies have the capacity to design and manufacture small harbour patrol boats. The local maritime industry does, however, have a limited capacity in naval electronics (including shipborne radar systems), systems integration (combat suites), ammunition (including naval bombs and mines), research and development and ship repair and maintenance. Batchelor and Dunne (2000) suggested that this sector was not particularly well placed to benefit from the Navy's acquisition programmes without significant investments to upgrade and expand its existing capabilities. Some of these predictions have become reality, as in January 2003, due to the installation of faulty copper communication cabling by a South African company, the delivery schedule of the corvettes was set back by a year (*Mail and Guardian*, 3/01/2003 and 15/02/2003).[14]

In contrast, South Africa's aerospace industry, which is concentrated in a few companies in Gauteng, had a relatively well-developed capacity to design and manufacture missiles, aerospace engines and fixed and rotary wing military aircraft. The industry also has significant capabilities in electronics (including radar), avionics, systems integration, weapons systems, and ammunition. Again, Batchelor and Dunne's assertion that this sector was well placed to benefit from the programmes has been proved accurate….

With the finalisation of the arms package, a number of European defence companies, including the preferred suppliers, made investments in local defence companies, particularly aerospace and IT companies. Most of this investment has involved equity purchases, rather than fixed investment in plant and capital. These equity investments were linked to the arms purchases from countries such as Germany, Italy, Sweden and Britain, but are also part of larger initiatives by European governments to promote increased trade between South Africa and themselves. There was also a growing number of joint ventures between European and South African defence firms. These joint ventures are significant in that they involve technology transfers, and should allow South African defence firms to become part of these European companies' global supply chains.

There was also some evidence of a significant impact on South Africa's defence exports. Some European governments have been 'prompted' to purchase South African defence products in favour of their own products, despite criticism from their domestic defence industries[15]. Some of the preferred European suppliers also helped South African defence firms to bid for, and win, foreign defence contracts.

South Africa has high unemployment rate. According to Statistics South Africa, the unemployment rate is estimated to be 29,4%, but the South African Institute of Race

[14] The original cabling allegedly had to removed and better quality cabling installed.
[15] For example, in early 1999 Denel's Somchem division was awarded a R1 billion contract to supply fuses for the AS90 155mm howitzer guns used by the British peacekeeping forces in Bosnia (Business Day, 6 January 1999).

Relations suggests that it may be as high as 36%.[16] Given this serious unemployment situation, the job creation aspects of the deal was of considerable importance.. The job creation estimates which were presented by government in September 1999 suggested that R104 billion worth of IP commitments will create approximately 65 000 jobs – this amounts to R1,6 million per job. This figure was extremely high and nearly 20 times higher than the average cost per job in the local defence industry. Batchelor and Dunne (2000) estimated that the R14,5 billion worth of potential DIP activities could create, or sustain, approximately 40 000 jobs (based on R350 000 per job) in the local defence-related industry[17]. While the foreign suppliers' defence purchases from the local defence-related industry, together with the prospect of increased defence exports, is likely to have a positive impact on job creation in local defence firms, any such estimates are open to questionable. In addition, even if the estimates presented above are accepted, they represent considerably fewer jobs than could be created if the money were used for other purposes than buying arms.[18]

Moving on to the non-defence component Government attempted to use the defence purchases to leverage substantial investment in the non-defence sectors of the South African economy. It has attempted to 'direct' this investment to particular sectors (minerals and energy) of the industrial economy and to specific parts of South Africa such as Kwazulu-Natal, the Western Cape and the Eastern Cape (The Star, 29 July 1999). It has also attempted to link it with other national economic and industrial policy initiatives (e.g. the DTI's Spatial Development Initiatives and Industrial Development Zones) (GCIS, 15 September 1999). Most of the promised offsets have still failed to materialise, or are dogged by controversy over their validity.

Batchelor and Dunne (2000) suggested that many of the promised investments were highly dubious and have been provide right. Their main example, the German submarine consortium's NIP proposal (valued at nearly R19 billion) which included the construction of a stainless steel plant by German company Ferrostaal at Coega near Port Elizabeth, and the establishment of a US$10 million venture capital fund to help SMMEs in the stainless steel industry. The steel plant was intended to form the anchor tenant for the planned deep water port at Coega. It is not happening and the initiatives that have replaced it are mired in controversy. For example, by August 2003, the condom factory in East London that was to be constructed with a substantial investment from Ferrostaal had still not materialised despite statements by Government that this initiative was one of the offset successes (*Mail and Guardian*, 25/7/03).

The record of employment creation associated with investment in strategic industries (e.g. Armscor, Sasol, Mossgas) and massive capital-intensive mega-projects (e.g. Columbus and Alusaf) is not particularly impressive. In many of these mega-projects the potential foreign exchange earnings are never repatriated, vertical integration does not take place and the job creation effects in downstream industries are never fully realised (Fine, 1997).

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[16] SAIRR. 2001: 333.

[17] . In 1997 the cost per job (remuneration costs per employee) in the public sector defence industry (Denel) was R93 722, while in the private sector (e.g. Reunert) it was slightly lower at R82 838. However, this is not an accurate reflection of the real costs associated with maintaining or creating jobs in the defence industry. In 1997 turnover per employee in the public sector defence industry (Denel) was R231 898 while in the private sector (e.g. Reunert) it was more than double - R464 633 (Batchelor and Dunne, 2000)

[18] Reallocations of defence spending to other forms of government spending have been shown to increase employment and output. See discussion in Dunne (1996)

**Costs and Benefits of Offsets**

Providing an accurate analysis state of affairs of NIP developments is virtually impossible at this given time due to the severe lack of reliable data. The South African Department of Trade and Industry (DTI), however, is providing positive spin on NIP delivery and related job creation. For example, in August 2003, DTI announced that most NIP projects were on track, and had already created 5,000 jobs, and would result in the establishment of a total of 15,000 direct jobs, and 50,000 indirect jobs by 2011 (*Business Day*, 12/6/03; *Business Report*, 11/8/03). However, independent defence analysts and investigative journalists have suggested otherwise.[19]

It is clear that the South African government made a serious attempt to develop IP policies that reflect the lessons learned by other countries. There are, however fundamental problems with offsets policies in general and the South African case in particular that are apparent in the available literature. There have been some concerns raised over the value of the offset deal to the South African economy. The limited but growing international literature on defence offsets and their economic effects, does not instil confidence. The impact of offsets is often found to problematic in terms of job creation, the strengthening of backward and forward linkages, and technology enhancement (Struys, 2001). Nor do they constitute a 'third way' for the economic development of LDCs (Matthews 2000; Batchelor and Dunne, 2000). A recent study of Saudi Arabia's defence offset programmes, reveals that instead of a proclaimed 75,000 local jobs, the various programmes had generated employment in the region of 2,000 (Matthews 2000). Few countries appear to have been successful in using defence offsets to utilise sufficiently, and embed and extend technology transfers. Those domestic defence industries that are expected to benefit from offset deals are often characterised by a 'technologically sophisticated conservatism' (BAEC 19987: 33; Batchelor and Dunne, 2000) which does not lend itself to the development of clusters of intellectual and social capital. What is required is a 'high degree of local technological absorptive capacity' to be achieved through a state-sponsored 'civil-military, Science and Technology strategy' (Matthews 2000). In addition, new modes of structuring technology-intensive production appropriate for the 'new economy' (Dunne and Haines, 2001).

There is still the possibility of firms reneging on agreements and simply paying the agreed penalties and whether the promised inward investment will take place and generate the numbers of jobs that have been promised. In addition there is the question of capacity within government (e.g. DTI and Armscor) to monitor the implementation of the NIP and DIP offers fully over time.

The local defence industry will certainly benefit from the direct offsets and while it might struggle to retain the capabilities to produce a range of advanced weapons systems it could become a part of the global industry as sub contractor to some of the foreign equipment suppliers. There are still concerns about the capacity and capability of the local industry to fully benefit, particularly in relation to the navy orders. While the local aerospace and electronics industry would seem to be benefiting significantly there is still the question of whether or not they can continue to survive once the orders are through. It is not clear whether the companies will be internationally competitive to allow the industrial

[19] See "The great arms for jobs sham," *Mail and Guardian*, 8/3/02; "Are the defence suppliers delivering?" *Business Day*, 13/5/03; "The sordid truth behind an arms deal," *Guardian*, 17/7/02.

development to be sustainable. Whether South Africa should be maintaining a defence industrial base at all is an important question, given the evidence that it can be a drain on the economy. Off the shelf purchases would have been cheaper and would have allowed the government to allocate the savings to encourage conversion in defence related industries. This would have allowed it to develop those areas of the economy with the highest potential for economic growth and job creation, thereby dealing more effectively with the current high levels of unemployment.

It would also seem that many of the foreign suppliers' NIP offers are questionable. It is not clear whether SA will be getting state of the art technology in areas of growth, or old technology in areas of overcapacity (e.g. stainless steel). In terms of the delivery of non-defence industrial participation, examples of the following developments have been reported in the media: a spinning and yarn-dying project at Cape Mohair in Port Elizabeth ($1,3 million investment from Agusta); manufacture of gold jewellery at Oro'Filk Gold in Cape Town ($5 million investment by Agusta); investment in a timber mill near Sabie by BAE-Saab ($90 million); upgrade of swimming pool facilities in Port Elizabeth aimed at promoting tourism in Scandinavian tourism (R10 million). The dangers are clear. After the economic damage the misallocation of resources to strategic industries and capital-intensive mega-projects caused under apartheid, it is important not to make the same mistakes again. It is not clear from our survey of the issues that the implications for industrial policy implicit in some of the offset offers have been fully thought out. It is certainly the case that the alternatives have not been given adequate consideration.

A related issue is whether government should be using its IP policies (and its human resources) to support the maintenance of a local defence production capability. It could support a strategic capability to assess and make informed choices between competing weapon systems (i.e. an intelligent customer capability). This would seem to be preferable given the costs of maintaining a local defence production capability, the current state of certain sectors of the defence industry, and the fact that the international market has relatively stagnant demand and excess capacity.

**Political fallout**

There has been a significant negative spin-off of the arms deal in political terms, which has reverberated throughout government departments, Parliament, Cabinet and the ruling party. In late-1999, in the immediate aftermath of Cabinet's approval of the arms procurement programme, allegations appeared in the public domain that certain officials who had been responsible for deciding on who the successful suppliers would be had received bribes from certain bidders. It is important to recognise, however, that commissions and bribes are all a part of the international arms trade and the companies are used to dealing with such inducements. This led Transparency International to call for an end to offset deals (TI , ???). The meeting of an inexperienced government with the shady dealing s of the internationals arms industry was always likely to lead to such problems.

One of the most vocal South African accusers was Patricia de Lille, a member of parliament for the Pan African Congress, a small opposition political party. These allegations, largely due to pressure from Parliament's Public Accounts Committee, resulted in a series of

investigations into the decision-making process with respect to the arms deal, the most significant of which being the joint investigation undertaken by the offices of the Auditor-General, the National Directorate of Public Prosecutions and the Public Protector. According to the report of the investigation, "no evidence was found of any improper or unlawful conduct by Government" (Auditor-General et al, 2001: 373). However, the report suggested that certain government officials had acted in an improper and irregular fashion. Particular mention was made of conflict of interest of Shamin "Chippy" Shaik, who was head Chief of Acquisitions in the Department of Defence at the time. The essence of this conflict of interest was that Shaik's brother, Schabir, had a company that had direct links with the Thomson Group (now Thales), one of the successful bidders, and would benefit from contracts awarded to Thomson CSF. Shamin Shaik was suspended from the Department of Defence in 2002, and resigned shortly thereafter.

Shamin Shaik was not the only political casualty, as in 2002 Tony Yengeni, the ANC Parliamentary Chief Whip was arrested on fraud and corruption charges as he had allegedly received a bribe from one of the bidders which he actively concealed from Parliament. In February 2003, Tony Yengeni pleaded guilty to the fraud charges in the Pretoria Commercial Crimes Court, and as a result was acquitted on the corruption charges. Yengeni was subsequently sentenced to four years in prison.

In 2002, evidence entered the public domain which suggested that Joe Modise, Minister of Defence at the time decisions on arms procurement were made, had a conflict of interest in terms of the arms deal. The reason being was that Modise and four other senior defence officials had controlling stakes in a company, Log-Tek (later Conlog Holdings) which had direct links with successful bidders. No action was taken against Modise as he died in November 2001, but the Directorate of Special Operations (also known as the Scorpions), which falls under the National Directorate of Public Prosecutions (Department of Justice), have initiated an investigation in this regard.

At the time of compiling this chapter, the Scorpions were investigating allegations of corruption, tax evasion and fraud against Schabir Shaik. During this investigation the Scorpions also investigated allegations that were made against Jacob Zumu, the South African Deputy President, that he attempted to solicit bribes from Thomson CSF Group (now Thales) with respect to the arms deal and future contracts. This investigation received extensive coverage in the national international media. In August 2003, the Director of Public Prosecutions announced that no legal action would be taken against Zuma as even though "there is a prima facie case of corruption against the deputy president, our prospects of success are not strong enough" (*Sunday Times*, 24/8/03). Shortly this announcement allegations emerged within the public domain that Ngcuku had been a spy for the security forces during the apartheid. With a serious crisis brewing within the ANC, President Thabo Mbeki in an attempt to limit the political damage, launched a judicial commission of inquiry, the Hefer Commission, into the Ngcuku spying allegations.

In terms of the investigation into the dealings of Schabir Shaik, he will appear in the Durban High Court in early 2004 on charges of corruption, tax evasion and fraud, many of which relate to the arms deal.

**Conclusions**

South Africa faced a number of economic challenges, including attracting foreign direct investment and creating jobs. In this context the government decided to spend nearly R30 billion on imported arms for the SANDF. At no point did the government considered try to limit the purchase costs of the SANDF's acquisition programme, by simply buying the cheapest off-the-shelf weapons (or even second-hand weapons). Instead, it invested considerable effort into negotiating offset offers from the foreign equipment suppliers to benefit the local defence related industry and the national economy.

Leaving aside the issue of whether the expenditure on arms was necessary at all on security grounds, the choice of imports with offsets was a risky one. The purported economic benefits of offsets have been questioned and what little empirical evidence is available suggests that they tend to have had a much smaller impact on the local economy than expected. It is very difficult to judge whether the prices are reasonable, given the fact that there are no market prices and no standardised goods in the defence market. It is also unclear whether the work attached to the offsets is genuinely new work at the same level of technology etc. It is also difficult to know if it is sustainable. There are certainly considerable doubts about whether South Africa really has benefited from the deal. At the same time the costs in terms of the political fallout are clear.

A more sensible strategy might be to leverage investment into sectors with a high capacity for mass employment creation and can make a positive contribution to South Africa's infrastructure capacity and towards meeting basic needs in public utilities sectors (e.g. housing, transport, tourism, energy, communication).

The South African experience certainly provides valuable insights into the positive and negative side of defence offsets for small industrialising and developing economies. It certainly casts doubts on the claimed benefits of purchasing arms with offsets.

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## Appendix 1: National Industrial Participation Policy

The evaluation of IP proposals and the awarding of IP credits are based on the following methodology:

| Objective | Methodology | Factor |
|---|---|---|
| Sustainable Economic Growth | Revenues accumulated over the fulfilment period | $1 = 1 Credit |
| Export Promotion | Export Revenues = Additional Credits | $1 = 1 Credit +LC* |
| Job Creation | Salaries and Wage costs accumulated over the fulfilment period | $1 = 1 Credit |
| Training and Development | Training and Development Costs accumulated over the fulfilment period | $1 = 1 Credit |
| SMME Promotion | Outsourcing to SMMEs | $1 = 1 Credit |
| Previously Disadvantaged Individuals | Outsourcing to PDI SMMEs<br>PDI Ownership % x Revenues | $1 = 2 Credits<br>$ x % = Credits |
| Investment | Capital outlay or capital injections | $1 = 2 Credits |
| R&D Expenses | All costs | $1 = 2 Credits |
| Technology Transfer | On a case by case basis linked to revenues | $1 = 1 Credit |

Source: National Industrial Participation Policy for South Africa, Department of Trade and Industry, Pretoria, April 1997

* LC = Local Content