Defence Offset Credits: Bankable and tradable

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Mandatory offsets in defence procurement are policy instruments used by numerous countries to develop their domestic industries. The policy amounts to import substitution by quantitative restrictions rather than duties and is mostly implemented behind the protective wall of security exemptions by tying the prime contractor to commit domestic business activity equivalent to the contract value of the procurement or somewhat less in the case of some countries.

To sweeten the deal, most countries use the offset multipliers that “relax” the protection constraint or, in other words, provide incentives to prime contractors by discounting its offset obligations if investments flow to priority sectors. We know that the efficiency of such policies depends on the absorption capacity or efficiency of a targeted industry. If this capacity is low, import substitution is expensive and the prime may rather choose to invest elsewhere in the economy to satisfy the overall mandatory offset constraint thereby thwarting the original objective. We also know that the uniform relaxation of offsets through multipliers can reduce distortions introduced by mandated offsets whereas, in general, multipliers may enhance distortions as an unintended consequence.

Two further efficiency-improving relaxations are the bankable or intertemporally tradable credits, which allow a contractor to use its past investments towards its offset obligations in future procurement contracts, and the tradeable offset credits, which allow inter-firm trades in offset credits just like in the case of pollution or biodiversity permits. We demonstrate that both modifications to offset policies are efficiency-enhancing.