



Federal Policy on Armament Procurements Abroad

An evaluation of compensation transactions

Key facts

When the Swiss Army procures armaments abroad, the foreign manufacturer is generally required to compensate 100% of the contracted amount through direct and indirect participation of the Swiss industry (industry participation, compensation transactions). Direct participation means that Swiss companies participate directly in the production of the armament to be procured. In the case of indirect participation, also called “**offset**”, the foreign manufacturer must place orders from Swiss industry arising from its own sphere of influence or arrange access to such orders for Swiss industry.

The question of industry participation regularly gives rise to action by Parliament during the consideration of armament programmes. At the request of the Security Policy Committee of the National Council, the Conference of the Bureaus of the Oversight Committees and Delegations (CBO) commissioned the Swiss Federal Audit Office (SFAO) to carry out an evaluation in this regard. The SFAO is called upon to investigate, over an extended period of time, how sustainable compensation transactions in the armament field are and how Swiss industry benefits from them. This research should indicate what types of compensation transaction make the most sense.

Object of the evaluation and issues raised

The object of the present evaluation consists in the industry participation transactions in the armaments field in Switzerland between 1995 and 2005. Based on the paper documents of armasuisse, the SFAO compiled the data on industry participations between 1995 and 2005, covering 28 armament procurement projects.

Roughly 1,000 Swiss companies participated with approximately 6,500 individual transactions in the industry participation volume amounting to a total of roughly CHF 4.3 billion (thousand million), or roughly CHF 400 million per year. One quarter consisted of direct industry participations, with a declining tendency. For this period, the SFAO examined

- whether the industry participation policy is based on consistent principles and guidelines,
- which sectors and companies in Switzerland benefit,
- how the compensation transactions affect the participating companies, and
- whether these effects are **sustainable** with respect to jobs (employment effect), additional order and export value or access to foreign markets (door opener effect), and receipt of knowledge or acquisition of additional know-how.

For this purpose, the SFAO conducted a survey with a representative sample of approximately 80 Swiss companies and other actors.

Imprecise, sometimes inconsistent principles

According to the SFAO, five objectives for industry participation can be derived from the existing principles on armament policy and Armament Reports to Parliament of the Federal Council:

- Maintenance of the industrial potential indispensable for the national defence



- 100% additional employment effect in Switzerland
- Competitiveness of the Swiss companies participating in offset transactions (adequate regional distribution is no longer required)
- Acquisition of additional know-how (offset transactions)
- Additional order and export volume abroad (offset transactions)

Several imprecise and sometimes inconsistent principles exist, which will be illustrated in the following examples.

With respect to the objective of “100% additional employment effect in Switzerland”, it should be noted that orders placed with Swiss supplier companies for which the added value generated in Switzerland amounts to at least 51% are, under current rules, credited to the economic compensation at a rate of 100% of their order value. This rule is inconsistent with respect to the employment policy. The criterion of additionality plays a key role in the industry participation policy. However, no verification is conducted as to whether additionality is actually achieved. Moreover: No detailed explanations exist with respect to expressions such as “*the industrial potential indispensable for the national defence*”. In several other European countries, detailed guidelines exist in this regard.

Low implementation costs for armasuisse and broad freedom of scope for foreign manufacturers

The specific design of the industry participation policy and its implementation is the responsibility of armasuisse. The necessary execution rules and procurement procedures are laid down in armasuisse’s business processes. The procurement contracts constitute the most important basis for industry participations. These contracts require foreign manufacturers to compensate the contract price through participation of Swiss industry. The direct participation transactions are carried out by the line organization, the indirect transactions by the Law and International Affairs division of armasuisse.

The Offset Declaration Statement (ODS) is an important tool for transacting the offset. With this form, a foreign manufacturer declares orders to armasuisse that the manufacturer has placed with Swiss suppliers and wants to have credited to the economic compensation. The ODSs have the status of a legal document and form the basis of controlling by armasuisse, but are not evaluated statistically. Controlling is undertaken by armasuisse in cooperation with the umbrella organization of the Swiss mechanical and electrical engineering industries (Swissmem). Swissmem may issue recommendations, but plays a subordinate role. The ODSs were an important data source for the present evaluation.

The SFAO noted that armasuisse places considerable trust in the manufacturers and the co-signing, participating Swiss companies. Certain information, such as the additionality of the orders, the added value, and often also the type of purchased product and other elements, such as the acquisition of additional know-how, cannot be verified simply on the basis of the ODS form and are rarely verified by armasuisse in direct contact with the Swiss suppliers. Often, the information provided is incomplete or imprecise.

In general, and also in an international comparison, armasuisse specifies few conditions for the offset and also has few resources at its disposal for implementation, especially with respect to con-



trols. The foreign manufacturers appreciate this flexible system, in conjunction with the good performance and competitiveness of Swiss industry.

The total additional costs of direct participations referred to in the Armament Reports to Parliament of the Federal Council between 1995 and 2005 amount to approximately CHF 53 million. The additional costs of offset are largely unknown. What is certain is that the offset obligations can be met in a comparatively cost-effective manner, since no structural policy is undertaken and Swiss industry is characterized by high performance and competitiveness.

Approximately 1,000 participating Swiss companies, but only few with a large order volume

The industry participation volume between 1995 and 2005 of a total of approximately CHF 4.3 billion was distributed unevenly in several respects among the Swiss industry. Firstly, the two comparatively small sectors Aviation and Weapons+Ammunition benefited in particular with large shares; secondly, a large share of the volume was allotted to only a few Swiss companies. Only 1% of the companies received CHF 80 million or more of industry participation. These ten companies, which in the following will be referred to as “large players”, together covered 44% of the total volume. Two thirds of the entire volume was allotted to 3% of the participating companies (the 30 largest suppliers). RUAG as the largest supplier company alone accounted for a share of 10% of the entire volume. Roughly 500 companies received a comparatively small share of industry participation.

In the 1995-2005 period, developments in the direction of smaller transactions and indirect industry participations can be observed. The regional imbalance of the industry participation volume, and in particular the below-average and sinking share of French- and Italian-speaking Switzerland, are striking. However, regional policy objectives are no longer expressly set out.

Much smaller Swiss employment effect than assumed

The employment effect of offset transactions is smaller than indicated in the Reports to Parliament on the armament programmes. According to the SFAO, effectively only about **40%** of the offset volume – and not 100% as assumed – flowed to Swiss industry. Firstly, this is due to fact that the bulk of the offset transactions did not exhibit any additionality and were subsumed under existing business relationships (daily business, *courant normal*) with the foreign manufacturer. Secondly, part of the offset volume flowed back to the suppliers abroad.

Low impact of industry participations

The other effects of industry participation should not be overestimated, since these transactions on average only amount to less than 2% of the turnover of the participating companies. In the case of the “large players”, the turnover share is 4%.

The analysis of the impact of the offset transactions shows that offset transactions can certainly have stimulating and sustainable effects on Swiss companies. However, these effects are limited to a small group of companies mainly consisting of the “large players” and only a few individual cases of small and medium enterprises. For the foreign manufacturers, it is easier to meet their industry participation obligations through their own branches in Switzerland, large groups, and well-connected sub-suppliers rather than through small and medium enterprises. Several disappointed small Swiss suppliers indicated in the survey that they had expected more orders in the framework of industry participations.



In general, it can be stated that the direct industry participation transactions have a better record than the offset transactions. This is especially true with respect to the abovementioned effects such as know-how-Transfer, promotion of innovation, and door opener effects.

Lessons from an international comparison

Armament procurement is not subject to the rules of the World Trade Organization (WTO) on public procurement or to the European Union competition directives. The overwhelming majority of countries demand industry participation in the context of armament procurement. These are primarily the countries that are heavily dependent on foreign producers for armament procurement and do not have their own armament industry capable of manufacturing entire “systems” itself. Each country has its own guidelines, and the differences between countries can be considerable. Both at the European level and also on the part of the industry of individual nations, efforts are underway to reduce industry participation transactions or to abolish them entirely. Conversely, there are also opposing trends to further expand such obligations.

In a general comparison, the Swiss offset policy is characterized by its flexibility. Only few conditions are imposed on foreign manufacturers with respect to fulfilment of their obligations: the principles of free competition, no structural or regional policy, great freedom with respect to the sectors to be considered, the type of the goods to be procured, and additionality of the offset transactions. This “low profile” policy is beneficial for the Confederation and the foreign manufacturers with respect to implementation costs and helps limit the additional costs for armament procurement. In this sense, it can be considered efficient.

On the other hand, the impact on the Swiss economy should not be overestimated. Although this policy concerns orders to industry of approximately CHF 400 million on average each year, not many of these orders are really additional (daily business, *courant normal*), and they only rarely concern transactions with an impact in terms of know-how-Transfer, promotion of innovation, or door opening effects (building up business relationships).

Recommendations

In general, the SFAO does not view offset as a truly future-oriented option for Swiss industry, although some offset transactions have entailed the strengthening or opening of markets for some Swiss suppliers. The current policy contradicts the spirit of free trade, leads to unofficial solutions, and has a rather low positive impact on the country.

The main recommendation of the SFAO consists in elaborating a transparent **strategy** on Swiss industry participation policy and its implementation. The goal is not to generate any false expectations on the side of Parliament and the Swiss supplier companies. On application of the Security Policy Committee, the Federal Council should position itself clearly with respect to these options in particular:

1. “Low profile“ status quo: this means low impact, high flexibility for foreign manufacturers, and in return lower implementation and procurement costs.
2. “100% additional employment effect in Switzerland”, which would entail more controls, a better ODS for offsets, and higher procurement costs.
3. “More effective industry participations for the national defence”, requiring a clear definition of the “industrial potential indispensable for the national defence”. “Multipliers” (multiple weighting of



transactions fulfilling this potential) could also be used, in order to enhance the quality of industry participation transactions with respect to achievement of the objectives.

4. “More effective industry participation transactions for the Swiss industry”: this means greater impact (know-how-Transfer, promotion of innovation, door opener effects), requiring a clear definition of these criteria. The use of multipliers would also be conceivable in this regard.

The more ambitious the goals, the more conditions imposed on industry participation, and the more controls necessary, the higher the costs would be for procurement and for implementation of the policy by armasuisse.

In addition, the SFAO has identified several optimization options in the areas of Controlling and Transparency. Through improved controlling and an increase of the threshold per transaction, the so-called “daily business” can be reduced, and the additionality can be increased. Cost/benefit transparency should also be improved, both by means of an accurate statement of the employment effect of the procurement volume in the Armament Reports to Parliament and by means of obtaining bids with/without compensation obligations.

The statement of armasuisse lies in Appendix 1. The SFAO took into account its different point of view. Nevertheless it maintains its recommendations without any amendment.

Original text in German