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Statement of

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before a hearing of the

Senate Committee on Foreign Relations

on

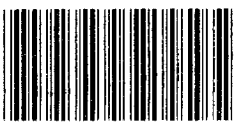
~~The~~ Impact of Raising or Repealing the

Commercial Arms Sales Ceiling

Mr. Chairman and Members of the Committee:

We are pleased to be here today to testify before this Committee on our review of the impact of raising or repealing the commercial arms sales ceiling.

Pursuant to Public Law 96-92, no commercial sales to foreign countries of major defense equipment in excess of $35 million are permitted, except to our 14 NATO allies, Japan, Australia, and New Zealand. Sales of major defense equipment prohibited by Public Law 96-92 can only be made under a foreign military sales agreement, which is a



government-to-government agreement subject to congressional veto authority under section 36(b) of the Arms Export Control Act.

Our review was directed toward a comparison of FMS and commercial arms sales and the effect of such controls on U.S. firms engaged in international arms trade. Overall, Mr. Chairman, we found that the ceiling has had very little impact on the international arms trade and that the export of major defense equipment can be effectively controlled with or without a commercial arms sales ceiling.

WHY DOES THE U.S. HAVE A CEILING ON COMMERCIAL ARMS SALES? For many years Congress has expressed deep concern about the effectiveness of control over arms sales to foreign countries. U.S. arms sales increased dramatically in the early 1970s, giving rise to renewed concern over the ability of the United States to control such sales. The Congress had urged restraint. Recognizing that there was a greater degree of control over arms sales on a government-to-government basis--the foreign military sales channel--Congress moved to shift significant commercial sales of major defense equipment into this channel. Imposition of the ceiling on commercial sales forced transactions into the foreign military sales channel, giving Congress veto authority over all significant sales of major defense equipment. The rationale behind the ceiling was that arms

export restraint, foreign policy, national security interests, and general supervision of military sales are all enhanced when sales of military equipment are handled on a government-to-government basis.

WHAT IS THE BASIC DIFFERENCE BETWEEN A FOREIGN MILITARY SALE AND A COMMERCIAL SALE? Essentially they are two different contracting methods. In an FMS sale, the Department of Defense, acting under the authority of the Arms Export Control Act, plays the role of a middleman between foreign governments and American manufacturers. If the U.S. Government approves an FMS purchase, an FMS price and delivery schedule are negotiated with the manufacturer. In short, the United States buys the equipment as if it were for U.S. forces and sells it to the foreign government. The United States transfers the payment from the foreign purchaser to the manufacturer and collects an administrative fee from the foreign purchaser to cover administrative costs of handling the transaction.

In contrast, on a commercial sale, the U.S. manufacturer and foreign country negotiate the price and delivery schedule. Payments are made directly by purchaser to seller. The U.S. Government role is to approve:

--The manufacturer's requests to promote or sell his product in the particular foreign country and

--An export license to deliver the equipment to that foreign country.

WHAT HAS BEEN THE IMPACT OF THE COMMERCIAL ARMS SALES CEILING? The ceiling did not significantly alter executive branch controls over commercial sales. Controls over arms sales do not distinguish between whether sales are FMS or commercial. The same Government offices review both commercial and FMS requests, applying the same criteria--including the President's arms transfer restraint policy. Some officials told us that the level of attention and degree of scrutiny are greater for FMS sales; however, this reflects the fact that significant sales are made on an FMS, rather than a commercial, basis and of course such sales should, and do, receive a more rigorous review.

Perhaps the most significant change in the controls over arms sales occurred in 1977, when the executive branch started requiring firms to seek approval before promoting sales of significant combat equipment. The institution of controls over foreign marketing of major defense equipment provided a mechanism for effectively controlling arms sales on a country-by-country basis and significantly reduced the need for a commercial arms sales ceiling. It is fairly safe to assume that a U.S. manufacturer would be denied an export license for any defense items on which it was refused approval for promoting sales in a specific country. The control over promotion permits the United States to make its arms control policy to be known by manufacturers on a weapon-by-weapon and

country-by-country basis, and tends to discourage a country from becoming interested in an item the United States does not wish to sell--even through FMS channels.

Most of the executive branch officials we interviewed believe that the U.S. Government should be directly involved in significant sales of major defense equipment. There are valid questions, however, as to whether the ceiling is necessary to keep significant sales in the FMS channel. The fact that most major defense equipment was designed for and purchased by the U.S. military tends to encourage foreign governments to place their procurement requests into the FMS channel.

Foreign countries tend to rely on U.S. expertise in purchasing major defense equipment. Such procurements usually contain numerous items manufactured by a variety of companies; some may be cheaper if purchased through the U.S. Government because of quantity buys; some must be purchased through the FMS program because they are manufactured in a U.S. Government arsenal. Highly classified items also tend to be sold through FMS channels. Statistics show that even before the commercial sales ceiling, the overwhelming majority of important sales to both exempt and non-exempt countries were on an FMS basis. All the significant pre-1976 commercial sales we examined were split sales with both FMS/ commercial contracts involved. They were made with U.S.

Government approval and, often, encouragement. Some customers believed that by using the commercial channel for a portion of the sale, they saved money and/or ensured earlier delivery. Some sales were split because an important component of the system being purchased could only be sold on an FMS basis.

The two foreign governments contacted during our review preferred FMS for major purchases. Many countries continue to buy major items on an FMS basis although current laws and regulations would permit their procurements on a commercial basis. Our review did not disclose any transactions which would lead us to believe that a commercial sales channel was chosen to avoid controls exercised over FMS transactions.

Although industry wants the flexibility of using the commercial channel when practical, only a few companies--primarily manufacturers of transport aircraft, helicopters, and armored personnel carriers--have been directly affected by the ceiling. Traditionally, these items were purchased commercially before 1976. The cost of these items--coupled with the quantity usually purchased--subject sales to the ceiling limitation more frequently. Many of the 14 companies we interviewed complained that some customers preferred commercial sales, deferred a planned purchase, or reduced the quantities to stay within the ceiling. Only a few companies claimed that they actually lost sales because of the ceiling. However, some executive branch officials believe that commercial sales would increase without the ceiling.

CONCLUSION

GAO believes that the question of maintaining, increasing, or eliminating the current $35 million ceiling on commercial arms sales depends a great deal on the extent Congress desires to be directly involved in the control process and is an issue which the Congress must determine for itself. Nevertheless, I would like to comment briefly on a few alternatives.

ELIMINATE THE CEILING

The ceiling could be eliminated if the Congress believes the commercial controls exercised by the executive branch, as described in chapter 2 of our report, are adequate. However, it should be recognized that Congress would be giving up its veto authority over a few types of high-dollar value equipment traditionally sold commercially which are now forced into the FMS channel by the ceiling. On the other hand, this approach might result in a slight increase in commercial exports of transport aircraft, helicopters, and armored personnel carriers. It is unlikely that procurement of tanks, missiles, and jet aircraft would shift to the commercial channel, as most countries would continue to purchase these items on a government-to-government basis. Several State and DOD officials told us, unofficially, that eliminating the ceiling would have little effect on the composition or volume of commercial sales.

SUBJECT SIGNIFICANT SALES TO SECTION 36(b) PROCEDURES

The Congress could eliminate the ceiling but still retain its veto power over significant commercial sales by subjecting those sales over a given amount to the reporting procedures required by section 36(b) of the Arms Export Control Act. Currently, the legislative veto contained in this section applies only to FMS sales. In effect, the Congress now has veto power over commercial sales; specifically, those FMS sales of $35 million or more that would have been commercial without the ceiling.

The procedure could be identical to FMS transactions which applies to all sales of major defense equipment over $7 million and all other sales of $25 million or more; thereby tightening congressional control over commercial sales. Commercial sales of defense equipment not classified as major defense equipment are not now subject to the ceiling or to congressional veto.

DECLARE PREFERENCE FOR FMS

The Congress could insert a clause in the legislation that the U.S. Government prefers major defense equipment sales to be arranged through FMS, but that exceptions would be permitted on a case-by-case basis. This approach was taken in the early 1970s, when the stated preference was for all sales to be on a commercial basis.

State Department officials expressed concern about what criteria would be used for granting exceptions. Possible criteria include that:

--the item has traditionally been sold commercially;

--the country has purchased the item commercially in the past; or

--the country requests permission to purchase the item commercially.

AUTOMATICALLY ADJUST CEILING FOR INFLATION

The Congress could retain the current-ceiling legislation, providing for an annual adjustment based on the rate of inflation. The Congress has accepted the premise that the same volume of commercial sales should be permitted today as in 1976, so this alternative would accomplish the objective if inflation is considered the sole cause of higher prices. Companies, however, have cited price increases in excess of the inflation rate as a result of product improvement.

RAISE CEILING SUBSTANTIALLY

The Congress could raise the ceiling substantially higher than the current $35 million. Most company officials indicated that a $50 million ceiling would solve the majority of their problems. If the ceiling were $75 million, they would have few, if any, problems. Aerospace companies, however, said a ceiling set at $100 million or higher would be more realistic.

A large increase in the ceiling would thus alleviate the current problems experienced by most companies. It would give companies more marketing flexibility and would give countries more purchasing flexibility. At the same time, this ceiling would still subject the most significant sales such as tanks, missiles, and jet aircraft to the FMS channel.

ADD WAIVER TO CEILING

The Congress could keep the ceiling and add a clause to the legislation that the President or Secretary of State could waive the requirements under certain conditions. This would provide an avenue for relief from the ceiling, but it might not be of much practical benefit. Formal waivers are usually viewed as an emergency measure. It might also be difficult to reach agreement as to which situations would qualify. Those companies whose sales do not qualify could complain that they were discriminated against.

RE-DEFINE TRANSPORT AIRCRAFT AND HELICOPTERS

The International Traffic in Arms Regulations (ITAR) could be amended to re-define transport aircraft and helicopters. The U.S. Munitions List, published in the ITAR, divides arms, ammunition, and implements of war into 22 categories. Category VIII covers "Aircraft, Spacecraft, and Associated Equipment," defining cargo-carrying or cargo-dropping aircraft and helicopters as significant combat equipment. Category VIII (a) could be divided into 2 sections. One section could

contain cargo-carrying or cargo-dropping aircraft and helicopters without a significant combat equipment designation. The other section could retain its significant combat equipment designation but exclude cargo-carrying aircraft and helicopters.

This alternative would solve the ceiling problem for the manufacturers of cargo-carrying aircraft and helicopters. Because these are normally high-unit cost items, the present ceiling permits the sale of only a small number on a commercial basis. As a result, companies contend that sales are being lost or reduced. It would, however, raise the issue of equitability by other companies who might feel that their items should also not be considered significant combat equipment.

This completes my statement, Mr. Chairman. We will be pleased to answer questions.