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Report to the Chairman, Subcommittee on Europe and the Middle East, Committee on Foreign Affairs, House of Representatives

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FOREIGN ASSISTANCE

U.S. Funds Used for Terminating Israel's Lavi Aircraft Program

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National Security and
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The Honorable Lee H. Hamilton
Chairman, Subcommittee on Europe
and the Middle East
Committee on Foreign Affairs
House of Representatives

Dear Mr. Chairman:

In January 1989 you requested that we determine the amount of U.S. foreign military sales (FMS) funds Israel used to terminate its Lavi fighter aircraft program. You asked us to determine how much Israel spent on the Lavi program after the decision to terminate the program was made; what the funds were used for, including if any were used for severance pay; and whether Israel plans to export any items or technology developed with U.S. funds and, if so, whether U.S. export controls would apply.

Between 1982 and 1987, Israel spent $1.4 billion in FMS funds to develop the Lavi, according to the Israeli Ministry of Defense (MOD). On August 30, 1987, Israel terminated the program because of rising costs and limited availability of funds.

Results in Brief

Israel spent $430.5 million in FMS funds to cancel contracts ($262.7 million) and to continue development and testing of selected avionics systems ($167.8 million) after the Lavi program's termination, according to information provided by the MOD. Of the total, $218.4 million was paid to companies in the United States and $212.1 million was paid to companies in Israel. No severance payments were made from FMS funds, according to MOD officials.

The principal Israeli contractor, Israel Aircraft Industries (IAI), continued to develop selected avionics systems started for the Lavi and to build an additional aircraft—called the technology demonstrator—on which to test these systems. The Department of Defense (DOD) agreed to the continuation of these programs. Test flights are scheduled to begin later this year. MOD spent FMS funds totaling $103.4 million in the United States and $64.4 million in Israel on these programs after the Lavi's termination. About $82.4 million (80 percent) of the amount spent in the United States was primarily to upgrade some engines for Israel's F-15 fighters.

Although the Israeli government and companies involved with Lavi would like to export products and technology still being developed, no agreements have been made with any foreign purchasers. Any retransfers of defense articles sold to Israel by the United States would be subject to (1) U.S. law and agreements with Israel requiring prior U.S. government approval or (2) retransfer conditions in the U.S. exporter's license. According to MOD officials, virtually all Lavi components developed by Israel have at least some U.S. content.

Background

In 1979, Israel decided to develop and produce the Lavi fighter aircraft. It was originally planned as a relatively unsophisticated low-cost fighter but later evolved into a much more technically advanced, more expensive aircraft. By 1985, officials in both DOD and the government of Israel had become concerned over the program's potential cost and the effect it would have on Israel's other defense programs. A 1986 DOD report concluded that Israel had seriously underestimated the cost of the Lavi program. The State Comptroller of Israel issued a report in 1987 that stated the decision to build the Lavi was made without an examination of the effect the Lavi would have on other defense programs. Israeli Defense Forces officials were also concerned that other programs would have to be postponed to pay for the Lavi.

In our 1987 report on the estimated costs of the program,[1] we projected that costs would soon exceed Israel's self-imposed Lavi spending cap of $550 million per year. In addition, we estimated that program expenditures would consume most of Israel's authorized $1.8 billion in annual U.S. military assistance near the end of the production run.

Under both internal and external pressure, the government decided to stop further development and production of the Lavi. DOD agreed to support various initiatives that would help Israel overcome the economic problems the termination would cause and help resolve the short-term problem of unemployment at IAI. (See app. I.)

Not all costs associated with the Lavi after its termination were for cancelling contracts. Some funds were used to continue development of avionics systems IAI believes the Israeli Air Force or foreign customers may buy and to upgrade 30 engines for some of Israel's F-15s.

[1] Foreign Assistance: Analysis of Cost Estimates for Israel's Lavi Aircraft (GAO/NSIAD-87-76, Jan. 31, 1987).

U.S. Funds Used for Termination and Related Costs

When the Lavi program was terminated, Israel had to terminate or complete active contracts and purchase orders. At that time, Israel had 136 open contracts and 1,500 active purchase orders with U.S. companies.[2] Eleven contracts remained active as part of the continuing programs. In addition, some purchase orders were issued after the program's termination for continuing programs.

As table 1 shows, Israel paid $218.4 million to U.S. companies and $212.1 million to Israeli companies to terminate Lavi contracts and fund continuing programs. All costs for contracts and purchase orders have been identified, according to MOD officials. They added that no further charges will be made to the Lavi program.

Table 1: Costs for Terminating Contracts and Continuing Programs

Dollars in millions

	FMS funds spent in	
Cost category	**United States**	**Israel**
Contract termination	$115.0	$147.7
Continuing programs	103.4	64.4
Total	**$218.4**	**$212.1**

Nearly 70 percent of the FMS funds paid U.S. companies ($152.2 million) went to one contractor—Pratt and Whitney. Of this amount, contract termination costs accounted for $69.8 million ($50 million was for a termination penalty included in the contract) while $82.4 million (54 percent) was spent as part of the continuing programs.

In Israel, MOD had contracts with two companies—IAI, for final aircraft assembly and certain components, and Bet Shemesh, for engines. These companies subcontracted with other Israeli companies for components and services. MOD paid $147.4 million in contract termination costs to IAI and $.3 million to Bet Shemesh. In turn, IAI paid $3.5 million to six subcontractors.

[2]Contracts were used for major systems, such as the engines and wings. They identify specifications and target quantities. Purchase orders were used to buy items identified within the contracts and for buying additional materials and services not included under a contract.

Table 2: Contract Termination Costs Paid to IAI

Dollars in millions

Category	Cost
Labor and direct charges, including subcontractors	$68.7[a]
Settlement payment	78.7[b]
Total	**$147.4**

[a]This includes salaries paid to employees who were laid off due to the termination from August 30, 1987, up to their separation date.

[b]This includes return of some research and development funds invested by IAI and its subcontractors.

According to MOD officials, no severance payments were included in termination claims paid with FMS funds to IAI and Bet Shemesh. Severance pay was not an allowed item and MOD refused to negotiate it. The companies' own funds were used to make severance payments to employees laid off due to the termination. IAI officials stated that IAI paid $135 million in severance payments to about 3,500 former employees.

Continuing Programs

The continuing programs included (1) developing selected Lavi avionics systems, (2) completing the technology demonstrator, and (3) upgrading 30 Israeli Air Force F-15 fighter aircraft engines. The first two programs were to test and demonstrate the Lavi systems. The engine upgrade program was to improve the capability of 15 Israeli F-15 aircraft (which has two engines per aircraft). All three programs offered continuing employment for Lavi personnel. The continuing programs accounted for $167.8 million (39 percent) of the $430.5 million charged to the Lavi program after termination.

Table 3: Funds Spent on the Continuing Programs

Dollars in millions

	FMS funds spent in	
Cost category	**United States**	**Israel**
F-15 engine upgrade program[a]	$82.4	$4.7
Technology demonstrator	21.0[b]	33.2[c]
Lavi avionics	0	26.5
Total	**$103.4**	**$64.4**

[a]The U.S. amount was for upgrade kits from Pratt and Whitney; the Israelis' amount was paid to Bet Shemesh for upgrade work.

[b]Primarily for materials.

[c]IAI paid subcontractors about one-third of the $33.2 million, according to MOD officials.

Israel purchased kits from Pratt and Whitney to upgrade 30 Israeli Air Force F-15 engines in lieu of receiving Lavi engines stipulated in the contract. Two of the upgrades were done by Pratt and Whitney in the United States to demonstrate the feasibility of the upgrade program. The remaining 28 are being done by Bet Shemesh in Israel.

Contracts with both Israeli and U.S. companies were continued for development of those avionics systems IAI believed the Israeli Air Force or foreign customers might buy. This program is near completion, according to company officials. These systems will be tested in the technology demonstrator.

MOD stopped financing the technology demonstrator in July 1988 for budgetary reasons but has continued financing development of some avionics systems. Since July 1988, IAI has continued building the demonstrator with its own funds. The first flight is scheduled for later this year, according to IAI officials. IAI plans about 100 flights, if funding is available.

Responsibility for the continuing programs was transferred from the Lavi Program Office to other MOD offices after March 31, 1988. Since then, continuing program costs have been charged to these other accounts.

Potential Export of Lavi Components

Many of the companies involved with Lavi are trying to increase their exports to compensate for reduced purchases by the MOD. For example, IAI and Elbit Computers have continued development of selected Lavi systems and components, in some cases using their own funds, because of potential future sales to both the Israeli Air Force and parties outside Israel. No agreements have been made with foreign purchasers, and these items are not yet ready for sale.

Any retransfers of defense articles sold to Israel by the United States would be subject to (1) U.S. law and agreements with Israel requiring prior U.S. government approval[3] or (2) retransfer conditions in the U.S. exporter's license. MOD officials said that Israel would need U.S. government approval to export any components with U.S. content. They added that virtually all Lavi components developed by Israel have at least some U.S. content.

[3]Sec. 3(a)(2) of the Arms Export Control Act, as amended, 22 USC 2753(c)(2).

Objectives, Scope, and Methodology

Our objectives were to determine how much U.S. FMS funding Israel used to terminate the Lavi aircraft program, how the funds were used, and what Israel's plans were regarding the export of items or technology developed with U.S. funds and whether U.S. export controls would apply.

We interviewed officials of Israel's Ministry of Defense in New York City and Tel Aviv, Israel; major aerospace and related industries in Israel; the Defense Security Assistance Agency and the Office of International Security Affairs, Department of Defense; and the Bureau of Near Eastern and South Asian Affairs, Department of State. We reviewed U.S. and Israeli contracts and related documents concerning the Lavi termination.

We requested comments from the Departments of Defense and State. Defense found the report to be factual and had no further comment; State did not have any comments. We also discussed the report with government of Israel officials and included their comments where appropriate. We conducted our review between January and July 1989 in accordance with generally accepted government auditing standards.

As arranged with your office, unless you publicly announce the contents of this report earlier, we plan no further distribution until 10 days from the date of the report. At that time, we will send copies to appropriate congressional committees; the Secretaries of Defense and State; and the Director, Office of Management and Budget. We will also make copies available to other parties upon request.

GAO staff members who made major contributions to this report were Albert H. Huntington, III, Assistant Director, and Edward D. Kennedy, Evaluator-in-Charge. If we can be of further assistance, please call me on 275-4128.

Sincerely yours,

Joseph E. Kelley

Joseph E. Kelley
Director, Security and International
Relations Issues

Additional Assistance Provided to Israel Related to the Lavi Termination

Prior to the decision to terminate the Lavi program, officials from Israel's Ministry of Defense and the Department of Defense (DOD) discussed what DOD would provide Israel to help minimize economic problems. DOD agreed to

- continue supporting the current level of foreign military sales (FMS) funding ($1.8 billion) for fiscal years 1988 and 1989,
- extend the authority for directed offsets[1] for fiscal years 1988 and 1989 at $150 million per year,
- support offshore procurement authority[2] at the level of $400 million per fiscal year for 1988 and 1989,
- allow Israel to use FMS funds to pay termination liability charges for Lavi contracts previously approved by the Defense Security Assistance Agency, and
- assist Israel in obtaining 1991 delivery dates and the most favorable terms and the lowest cost possible from General Dynamics for the F-16 aircraft ordered after the Lavi program was terminated.

DOD has supported extension of the current level of FMS funding and directed offsets through fiscal year 1989, as requested by Israel. DOD has also worked with Congress to increase the off-shore procurement authority to $400 million and authorized Israel to use FMS funds to pay termination liability charges. General Dynamics is to begin delivering the F-16s in May 1991, 3 years after the sale was agreed to.

DOD also offered to assist Israel in identifying feasible cost-effective coproduction schemes for assembling F-16s in Israel, according to MOD officials. Ideally, Israel wanted to set up an assembly line for its current purchase of F-16s. However, Israel could not and retain its short delivery time frames.

In addition, the government of Israel asked DOD to support a number of other issues to help Israel overcome the economic problems the termination would cause. Israel's request included

- placing orders by U.S. military commands in Europe for maintenance and engineering services to be carried out in Israel,

[1]Directed offsets represent purchases of components and services U.S. companies are required to make from Israeli subcontractors for incorporation in items which these businesses have contracted to sell to the government of Israel.

[2]Since 1984, Israel has been authorized by the Congress to spend part of its FMS funds for defense articles and services, including research and development, in Israel.

- granting Israel a waiver for nonrecurring costs for major items bought in the United States, and
- reducing administrative and management fees on FMS-funded purchases from the U.S. government.

On the first item, it was agreed that Israel could start competing for these orders. A DOD official stated that no major orders have been awarded to Israel. On the last two items, the Congress granted Israel a one-time waiver[3] of administrative and nonrecurring costs for the procurement of F-16s Israel agreed to buy after the Lavi termination. The waiver relieves Israel from paying $90 million over the duration of this purchase of F-16s. (The Congress also relieved Egypt of $49.7 million in administrative and nonrecurring costs on a similar aircraft sale.)

[3]Sec. 586 (b) of P.L. 100-461, the Foreign Operations, Export Financing, and Related Programs Appropriations Act, 1989, Oct. 1, 1988.

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