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MILITARY SALES

Concerns Over Offsets Generated Using U.S. Foreign Military Financing Program Funds

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Madam Chairwoman and Members of the Committee:

It is a pleasure to be here today to discuss the results of our report on offset arrangements associated with foreign military sales financed through the U.S. Foreign Military Financing (FMF) Program.[1] Various companies, countries, and government agencies define offsets differently--some even call offsets by other names, such as industrial participation or cooperation. For purposes of our review, we define offsets as an entire range of industrial and commercial compensation practices provided to foreign governments and firms as inducements or conditions for purchasing military goods and services.

When buying weapon systems with their national funds, foreign countries commonly require offsets to reduce the financial effects of making large weapons purchases abroad and make them more politically palatable domestically. Our work focused on countries that require or request offsets when purchasing weapons from the United States with U.S. grant aid (cash assistance) or loans through the FMF program.[2]

Over the years, we have reported on various offsets connected with foreign military sales. In this review, we examined in detail 48 contracts valued at $11.6 billion with the four largest recipients of FMF assistance--Israel, Egypt, Turkey, and Greece--along with the $4.7 billion in associated offset obligations.[3] We also traced the offsets through the companies' financial records and determined whether and how U.S. government funds paid for the offsets and their costs. Finally, we made observations on the impacts of these offsets on U.S. business, trade, and industrial competitiveness.

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[1] Military Exports: Concerns Over Offsets Generated With U.S. Foreign Military Financing Program Funds (GAO/NSIAD-94-127, June 22, 1994).

[2] Grants represent assistance for which the United States receives no dollar reimbursement. Grants generally refer to military assistance program funds, non-repayable or forgiven foreign military sales credits, and repayable foreign military sales credits that were later forgiven. On the other hand, loans generally refer to direct loans or repayable foreign military sales credits that are made at either market or concessional rates.

[3] Specific information about offset arrangements was considered proprietary by the U.S. contractors. As a result, information is provided in summary form, and the contractors are not identified.

RESULTS IN BRIEF

The U.S. FMF program has been justified to the Congress based on its role in (1) strengthening the security of friendly and allied countries and (2) benefiting the U.S. industrial base and employment because the funds are generally to be spent buying U.S. goods and services. However, current U.S. laws, policies, and regulations do not preclude offsets when recipients are making purchases with FMF funding.

Using U.S. FMF funds, Israel, Egypt, Turkey, and Greece benefited in two ways--first with the U.S. government funding or underwriting their weapons purchases with grants or loans, and then by developing their industrial bases and other aspects of their economies through offset requirements from the U.S. government or contractors. Offsets reduce the employment, defense industrial base, and other economic benefits that normally accrue to the United States from weapons exports. Certain types of offsets have resulted in a loss of some production work and business for U.S. prime contractors and subcontractors as well as for companies in nondefense businesses. On top of this, FMF grants and loans or military procurement funds actually pay for some offsets and their costs.

Department of Defense (DOD) officials stated that no other arms supplier provides a combination of grant aid and offsets like the United States.

U.S. LAW, POLICY, AND REGULATIONS DO NOT PROHIBIT OFFSETS WITH FMF FUNDS

Current U.S. laws, policies, and regulations do not preclude FMF recipients from requiring, requesting, or obtaining offsets when they purchase U.S. military goods and services using FMF funding. The Arms Export Control Act provides that FMF grants and loans should not be used for coproduction, licensed production, and procurements outside the United States except under certain limited conditions. But this Act and other applicable laws do not prohibit foreign countries from using FMF grants and loans to obtain offsets from U.S. weapons suppliers.

The President's 1990 offset policy includes an exception that is not defined and actually allows U.S. government funds to pay for offsets in security assistance transactions. Although the policy says that U.S. government funds shall not be used to finance offsets in security assistance sales except in accordance with currently established policies and procedures (emphasis added), it does not spell out what "currently established policies and procedures" are. Under the policies and procedures existing in 1990, many types of offsets, including coproduction and designated work, were occurring in connection with sales financed with U.S. FMF grants and loans. As a result, this policy does not really prohibit U.S. funds from being used for offsets in security assistance sales. This policy was later incorporated into the Defense Production Act in 1992.

<u>RECIPIENTS LEVERAGE OFFSETS WITH U.S. FMF FUNDS</u>

To varying degrees, Israel, Egypt, Turkey, and Greece are using U.S. FMF program funds to obtain offsets. Offsets are either direct--related to the weapon system being bought--or indirect--related to other products and services. As shown in attachment I, $4.7 billion in offset obligations were generated from the $11.6 billion in contracts we reviewed.[4]

Direct offsets associated with the FMF contracts we examined included coproduction and buybacks:

-- <u>Coproduction</u> agreements permit a foreign country to produce all or part of a U.S. weapon system overseas. In the cases we reviewed, coproduction activities valued at $1.2 billion took place in Turkey, Israel, Greece, and Egypt. In one case, for instance, using FMF assistance and national funds, Turkey produced parts and components and assembled the final weapon system valued at about $760 million.

-- <u>Buybacks</u> involve the U.S. contractor enabling the foreign country to produce defense components directly related to the U.S. military system being acquired and then purchasing these components from the foreign country. Buyback arrangements have been made with Israel, Turkey, and Greece. For example, Israel and Turkey were sources of buybacks valued at $631.2 million and $316.9 million, respectively.

We also saw a variety of indirect offsets in the cases we reviewed:

-- <u>Procurements</u> involved purchases of foreign-produced components of weapon systems other than those being acquired. For example, to implement an offset for purchasing a U.S. tank, a contractor might buy aircraft parts from the purchasing country. In the cases we reviewed, U.S. contractors made most of these types of purchases from Israel and incorporated them into weapon systems or commercial items that were purchased by U.S. and foreign customers.

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[4]Because our selection of cases represented a small percentage of military sales, the results of our work cannot be projected to a larger universe of military offset arrangements.

-- Investments in non-defense firms involved establishing corporations in Greece and Turkey to invest capital in companies in those countries. For example, U.S. contractors financed a Greek corporation, which in turn invested in companies engaged in medical diagnostics, sportswear manufacture, computerized numerically controlled wire-bending machines, software systems for the financial services industry, and woven and nonwoven textiles.

U.S. FUNDS PAY FOR SOME OFFSETS

FMF grants and loans and U.S. military procurement funds have been used to pay for items produced overseas under offset agreements, and for some costs associated with offsets. In some cases, such as coproduction or directed subcontracting, the use of FMF grants and loans to pay for or finance offsets is clear. In other cases, such as buybacks and other procurements, the U.S. government, as an ultimate buyer, pays for foreign-made components that are included in U.S. weapon systems purchased by the U.S. military services as a result of the offsets.[5]

-- The cases we reviewed included FMF grant-funded coproduction and directed subcontracting valued at about $387.9 million. For example, Israeli companies were paid to produce parts that were incorporated into weapon systems that the United States provided to Israel free of charge.

-- The U.S. military services and other customers purchased weapon systems that contained about $1.5 billion in components acquired through buybacks or other procurements made by the U.S. contractors. Of this amount $1.2 billion in buybacks or other procurements were made from Israel. Neither we nor the contractors could quantify or distinguish the total amount of U.S. funds used for these purchases.

Because the purchase prices of foreign-produced parts and components are ultimately paid by customers, including the U.S. military services, the actual out-of-pocket costs of offsets to the U.S. contractors are substantially lower than the total amount of the offset obligations.

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[5]U.S. contractors stated that buybacks and other procurements were made at competitive or reasonably competitive prices and did not result in extra costs to the government. Nevertheless, buybacks and other procurements result in additional foreign content in U.S. weapons.

OFFSETS ARE A QUESTIONABLE USE OF U.S. FMF FUNDING

While FMF grants and loans support U.S. foreign policy and security objectives, certain types of offsets reduce the employment, industrial, and other economic benefits that normally accrue to the United States from foreign military sales. Some offsets require U.S. contractors to place subcontract business offshore with recipient countries' industries that might have otherwise been performed in the United States. Our review indicates that offsets can result in displacement of U.S. subcontractors and create new competitors for U.S. companies in the world market.

Although the long term impact of offsets on overall U.S. trade and employment depends on a number of factors, effects of offsets on certain industries and firms can be identified. Our report discusses a number of anecdotal cases in which offsets connected with sales funded wholly or partially with grant aid adversely affected U.S. companies' business. I will highlight two of these cases for you.

-- Because of buyback arrangements with Israel, a U.S. subcontractor that originally supplied a subsystem was no longer producing the item. In this case, the U.S. subcontractor was displaced by an Israeli supplier for that item. According to the subcontractor, this significantly affected the company's operation and reduced yearly revenues by about $2 million, or almost 15 percent.

-- In another case, U.S. prime contractors provided Turkey with the capability to produce parts and components that were incorporated in the weapon system sold to Turkey as well as components purchased back to be included in U.S. weapon systems. Two subcontractors told us they lost work that could not be replaced. Both U.S. companies noted that as a condition of their contracts with the U.S. prime contractor, work had to be given up so that the prime contractor could satisfy its offset obligations.

While offsets are an integral part of the world marketplace, they are not needed to assure a sale of a U.S. weapon system and may not be appropriate when the purchasing country is using FMF funding. According to DOD officials, the FMF grant aid program is unique in the world. No other arms supplier has a program that provides a combination of grant aid and allows offsets. In sales financed with FMF funding, especially FMF grant aid, foreign competition is not a factor because these funds are generally intended to purchase U.S. military goods and services. Instead, U.S. companies are competing against each other for FMF grant-funded purchases.

In discussing the possibility of prohibiting FMF recipients from using FMF funds to require offsets, both DOD officials and the U.S. contractors we contacted voiced concerns about a prohibition on obtaining offsets using FMF loans because the recipients repay these loans with their national funds. We agree that FMF recipient countries intend to repay FMF loans with their national funds. However, some loans have been provided at concessional rates or have been forgiven at a later date.

DOD and contractor officials also noted it would be extremely difficult to enforce a prohibition on offsets using FMF grant funds. To ensure enforceability, contractors could be required to certify that they have not and will not provide offsets in connection with grant-funded sales. Certain contractor representatives noted that the United States could also include a prohibition on requiring or obtaining offsets as a condition of the grant aid.

Our report makes some suggestions to the Congress for amending current legislation to prohibit the questionable use of FMF funds and to help with the enforceability of the new laws.

Madam Chairwoman, that concludes my statement. I will pleased to answer any questions that you or other Committee Members may have.

Attachment I

TYPES OF OFFSETS AND ASSOCIATED OFFSET OBLIGATIONS

Dollars in millions

Types of offsets	Cases[a]	U.S. contractor offset obligations
Direct offsets		
Coproduction arrangements	9	$1,155.0[b]
Buybacks (related to the system)	11	941.1
Directed subcontracting	6	14.9
Investments (defense firms)	3	159.4
Concessions	10	166.3
Technology transfers/licensed production	15	[c]
Indirect offsets		
Procurements (unrelated)	11	584.3
Various offsets	2	901.0[d]
Investments (nondefense firms)	1	33.0
Trading of commodities	5	545.1[e]
Foreign defense-related projects	6	226.7
Total		$4,726.8

[a]Many of the cases we reviewed involved more than one type of offset. Therefore, the number of cases displayed in this table exceeds our sample quantity of 48.
[b]The contractor could not quantify the value of parts and components purchased from one country. As a result, this figure does not include that amount.
[c]The values of these offset obligations were not quantified because they were based on subjective judgments or not known in all situations.
[d]Through subsequent negotiations between the U.S. contractors and the FMF recipients, these offset obligations were later satisfied with U.S. contractor investments in nondefense firms. These investments cost $37.8 million.
[e]Offset obligations amounting to $28 million could be satisfied through either the trading of commodities or foreign defense-related projects.

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