

GAO

Report to the Chairman, Subcommittee
on Investigations, Committee on Armed
Services, House of Representatives

April 1991

EUROPEAN
INITIATIVES

Implications for U.S.
Defense Trade and
Cooperation



143601

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**National Security and
International Affairs Division**

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The Honorable Nicholas Mavroules
Chairman, Subcommittee on Investigations
Committee on Armed Services
House of Representatives

Dear Mr. Chairman:

This is an unclassified version of our classified report on European initiatives towards forming a single integrated market and their implications for U.S. defense trade and cooperation. It was prepared in response to your request.

In chapter 6 of this report, we make recommendations to the Secretaries of State and Defense for improving interagency and internal coordination on and assessments of the defense trade implications of European initiatives within the Departments of State and Defense and on other matters.

As arranged with your staff, we plan no further distribution of this report until 30 days from its issue date. At that time, we will send copies of this report to other interested congressional committees, concerned U.S. embassies in Europe, and the Secretaries of State and Defense.

This report was prepared under the direction of Joseph E. Kelley, Director, Security and International Relations Issues, who may be reached on (202) 275-4128 if you or your staff have any questions. Other major contributors are listed in appendix IV.

Sincerely yours,

A handwritten signature in cursive script that reads "Frank C. Conahan".

Frank C. Conahan
Assistant Comptroller General

Executive Summary

Purpose

Prompted by growing interest in and concerns over the potential effects on U.S. defense trade and cooperation with European countries, the Chairman, Subcommittee on Investigations, House Armed Services Committee, asked GAO to examine European initiatives toward forming a single integrated market. Specifically, GAO (1) reviewed activities and initiatives of two European organizations—the European Community (EC) and the Independent European Program Group—and their effect on U.S. defense trade and cooperation; (2) identified defense trade activity under reciprocal procurement agreements during the 1980s with the European allies of the North Atlantic Treaty Organization (NATO); and (3) examined the roles and organizations of numerous offices in the Departments of State, Defense (DOD), and Commerce and in the Office of the U.S. Trade Representative to determine how U.S.-European defense trade and cooperation issues were being monitored, assessed, and managed.

Background

U.S. and European perceptions of a declining threat from the Soviet Union, pressures to cut defense spending, and overcapacity in defense production worldwide will seriously affect the U.S. defense industry. Within this context, parallel plans are underway in the EC and the Independent European Program Group to restructure European defense industries to become more competitive with the United States. An inter-agency task force coordinates U.S. positions on the civilian issues related to the European single market program, but does not cover Independent European Program Group activities or defense trade and security issues. The Independent European Program Group is an inter-governmental organization that is not formally part of NATO but whose membership includes all the European members of the alliance except Iceland.

Results in Brief

EC initiatives on defense tariffs, rules of origin, product standards, mergers and acquisitions, and export controls have important implications for U.S. defense trade and technology transfer policy. In addition, the Independent European Program Group is implementing a plan that could foster a greater preference for European firms to conduct defense research, development, and procurement and could potentially exclude the United States.

Since the late 1970s, the U.S. defense trade advantage with the European allies has significantly declined, according to DOD estimates. This decline has caused some government and industry observers to question

the continued usefulness of reciprocal defense procurement agreements. Although difficult to prove, U.S. government and defense industry representatives have perceived a growing preference for European firms in European defense contract awards.

No single State or Defense Department office serves as a focal point to fully address the defense trade implications of initiatives of the EC, Independent European Program Group, or other European organizations. The result is a fragmented approach to the issues. State and Defense offices' recommendations to better monitor and coordinate U.S. policy on these matters have not been acted upon. Improved internal coordination within State and Defense and a higher level interagency approach could help ensure that U.S. interests are fully addressed.

Principal Findings

Effects of European Initiatives on Defense Trade

While the European single market process is focused primarily on the civilian sectors, European Community initiatives will also affect the defense sector and may affect technology transfer and reexport controls. For example, the way in which the EC applies its merger and acquisition rules allows large European defense conglomerates to form. In addition, EC rules of origin could be applied to certain imported U.S. defense goods and result in additional duties. Finally, while the EC currently defers to a multilateral forum on export controls, it is considering a Europe-wide rule that would challenge reexport controls in U.S. legislation and regulations.

In an effort parallel to that of the EC, the Independent European Program Group is working to integrate the European defense market and industry. It is making progress with its plan to improve cross-border defense contracting among the member countries and to better coordinate European defense research and development. The plan also involves studying ways to eliminate project-specific offsets among the member countries in favor of *juste retour*—a long-term view of a fair return for a purchasing country's investment in a weapons program. A number of elements of the Group's program and plans, if successful, could result in the exclusion of U.S. industry.

U.S.-European Defense Trade Agreements and Activity

During the 1970s, the United States entered into bilateral reciprocal defense procurement agreements with most of its European NATO allies with the intent of promoting rationalization, standardization, and interoperability of defense equipment within the alliance; improving the two-way street in defense trade; and reducing the significant U.S. advantage in this area. DOD's estimates show that the U.S. defense trade advantage has declined significantly from a ratio of about 8 to 1 in the late 1970s to 2 to 1 in 1987. Although GAO questions whether the ratio was as high as DOD's estimates in the early years, GAO's alternative estimate also reveals a decline in this advantage. While the United States waives customs duties and "buy national" requirements for imports from the European NATO allies, the agreements do not specifically guarantee U.S. suppliers duty-free access to European countries' defense markets. Some European countries pay tariffs on U.S. defense equipment and consider tariffs when evaluating bids. This could place U.S. suppliers at a competitive disadvantage since the EC eliminated internal customs duties in favor of common external tariffs. Some U.S. government and industry officials question the continued usefulness of the agreements.

While difficult to prove, U.S. government and industry officials perceive an increasing European preference for European firms in defense contract awards and new programs. A number of factors contribute to the perceived trend toward European preference in contract awards and new programs. These factors include (1) similar military missions and equipment requirements among the European allies, (2) Independent European Program Group and single market initiatives promoting a more unified European defense sector, and (3) politically motivated defense procurement decisions.

U.S. Monitoring of and Response to European Initiatives

While an interagency task force and the Commerce Department are monitoring the civilian implications of EC initiatives, they do not include issues that specifically concern defense trade or the Independent European Program Group. Although more than 25 offices in State and DOD are concerned about the implications of these initiatives for defense trade, there is no coordinated monitoring, assessment, or policy formulation. While the U.S. government effectively organized a U.S. response to the EC defense tariff initiative on an ad hoc basis, many issues remain unaddressed. Offices within State and DOD have made recommendations for improving assessment of the impact of European initiatives on defense trade and security matters and coordination of U.S. policy, but they have not been acted upon.

Recommendations

GAO makes recommendations to the Secretaries of State and Defense for improving interagency and internal coordination and assessing the defense trade implications of European initiatives in chapter 6 of this report.

Agency Comments

As requested, GAO did not obtain written comments from State and DOD. However, GAO discussed its findings and recommendations with responsible agency officials and has included their comments as appropriate.

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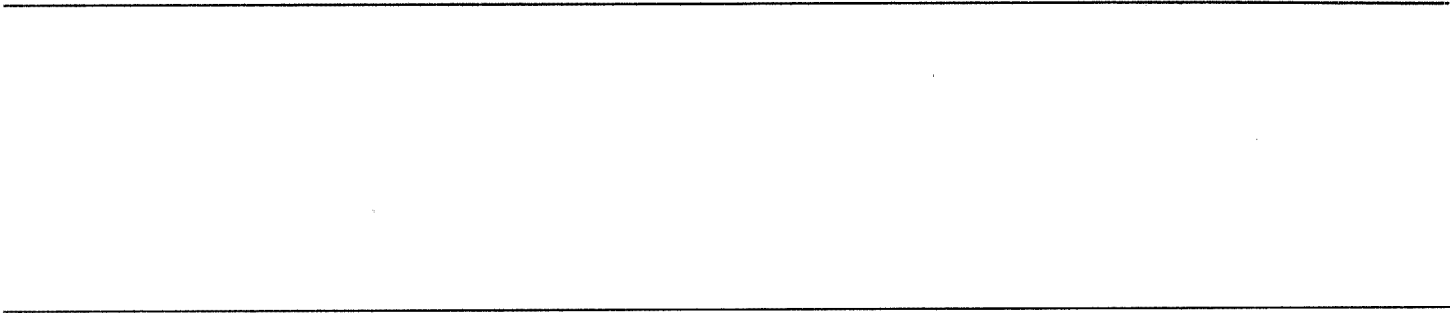
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Abbreviations

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| COCOM | Coordinating Committee for Multilateral Export Controls |
| DOD | Department of Defense |
| EC | European Community |
| EUCLID | European Cooperation for the Long-term in Defense |
| FMS | Foreign Military Sales |
| GAO | General Accounting Office |
| IEPG | Independent European Program Group |
| MOU | Memorandums of Understanding |
| NATO | North Atlantic Treaty Organization |
| R&D | Research and Development |



Introduction

The future of the U.S. defense industry will be shaped by the rapidly and dramatically changing political and military environment. Political events in the Soviet Union and eastern Europe, U.S. and European perceptions of a declining Warsaw Pact threat, pressures to cut defense spending, future treaty negotiations, changing weapons technologies, and overcapacity in defense production worldwide will seriously affect the U.S. defense industry. Within this context, Europe is attempting to consolidate and restructure its defense industries and markets to become more competitive with the United States.

In the late 1970s, the United States entered into bilateral reciprocal procurement agreements with its European allies, intending to reduce the large defense trade advantage it had and establish a two-way street in defense trade. This U.S. advantage has significantly declined since the first agreements were signed in 1978. An interagency task force, chaired by the U.S. Trade Representative, monitors and coordinates U.S. positions on civilian issues related to the European single market program, but it is not responsible for defense trade, cooperation, and security issues.

Defense Trade and Cooperation in a Rapidly Changing Environment

Political events in the Soviet Union and eastern Europe, conventional force reductions, and other world trends have dramatically altered the operating environment for defense trade and cooperation. These changes in environment, along with the Europeans' efforts to form an integrated defense market, have important implications for the U.S. defense industry. The perception of the Soviet Union and the Warsaw Pact as a military threat has decreased markedly. Cohesion of the North Atlantic Treaty Organization (NATO) and the U.S.-European defense industrial relationship have been based largely on the Soviet threat. The movements toward political and economic unity are giving the Europeans confidence to develop a more assertive approach to their security concerns, both politically and industrially.

The perception of a declining threat is also resulting in pressures to cut defense spending in both the United States and Europe. Governments and populations are no longer supportive of large defense expenditures. Decreased defense budgets will result in fewer defense acquisitions, both in the United States and Europe. In addition, the Treaty on Conventional Forces in Europe and any follow-on accords will establish ceilings on a number of categories of weaponry in Europe and significantly reduce those forces.

At the same time, changes in technology are resulting in the escalating costs of major weapon systems and equipment as well as research and development. As more high technology is placed in equipment with smaller production runs, the costs for successive generations of systems will continue to spiral. Most nations can no longer afford to maintain an across-the-board defense industrial base. Foreign military sales will become increasingly important to maintaining U.S. and other countries' defense industrial bases.

The unprecedented political change in Europe also coincides with overcapacity in defense production worldwide. The emergence of Brazil, China, Israel, and South Africa as major arms exporters, coupled with the reduced perception of threat, is resulting in more competitors in a shrinking arms market. U.S. government and industry observers of the defense market expect defense industries to diminish, according to one analysis, by as much as one-third. Small- to medium-sized firms that serve as subcontractors and suppliers of components are expected to be particularly hard hit by this reduction.

Changes in technology are also contributing to the transformation of the defense market. Defense and civilian technologies increasingly overlap. Composite materials, telecommunications, and information technologies, for example, have both civilian and military applications. According to a European industrialist, electronic equipment will account for over 40 percent of the next generation of combat aircraft costs. The broader use of dual-use technologies could have the effect of pushing many defense contractors further into civilian markets.

This changing environment is providing the broader context within which the Europeans are attempting to consolidate and restructure their defense industries and markets. The final outcome is unclear, but most observers believe the Europeans will emerge as a more competitive force in the global defense market.

Market Plans of the European Community and Independent European Program Group Are Parallel

In 1985, the European Community (EC) approved a program to remove all physical, technical, and fiscal barriers to internal trade by December 31, 1992. This program, known as EC 92, will affect all goods traded in or with the EC. Created by the Treaty of Rome in 1957, the EC has 12 member states (see table 1.1), a market of over 320 million people, and a combined gross domestic product comparable to that of the United States.

The Treaty of Rome envisioned a single, integrated European market. While some progress was made regarding the free movement of goods and persons, a number of barriers persisted, preventing the creation of a genuine single market. In the early 1980s, interest in EC integration accelerated because European businesses perceived that fragmentation of the European market was causing the EC to be less competitive with the United States and Japan. In 1985, the EC approved the 1992 program with the goal of removing all barriers to the free movement of goods, services, capital, and people within the Community. A White Paper entitled "Completing the Internal Market," which was prepared by the European Commission, the executive arm of the EC, listed almost 300 measures to achieve the single internal market.

While the single market program is focused primarily on the civilian sectors, security and defense concerns are increasingly moving to the forefront. Economic factors provide the Commission numerous opportunities, in the EC's name, to expand its authority into security and defense issues. For example, the Commission's proposal to harmonize tariffs on defense items imported into the EC, forays into technology transfers and export control practices, and regulations concerning product standards and mergers and acquisitions have potential implications for defense trade and technology security.

Controversy surrounds the Commission's jurisdiction in intervening directly in defense trade and security matters. Article 223 of the Treaty of Rome (see app. II) allows member states to take measures they consider necessary to protect their security as it relates to armament production or trade. Some European governments have used article 223 to exempt a broad range of defense items from common EC customs duties based on national security concerns. However, article 30 of the 1986 Single European Act also pledges the EC member states to more closely coordinate their positions on the political and economic aspects of security and to maintain the technological and industrial conditions necessary for their security. Many believe this legislation provides the basis for adding defense and security issues to the Commission's purview.

According to some observers, however, since defense and security issues are politically sensitive, the Commission may defer direct action on these matters while it pursues its vast agenda on civilian activities.

Parallel with the EC's movement toward economic integration, the Independent European Program Group (IEPG) is actively working to develop an integrated European armaments market. The IEPG is an intergovernmental organization that is not formally part of NATO but whose membership includes all the EC members of the alliance, plus Norway and Turkey (see table 1.1). Established in 1976, IEPG's objectives are to promote European cooperation in research, development, and production of defense equipment; improve transatlantic armaments cooperation; and maintain a healthy European defense industrial base. The IEPG member states recognize that their defense industries suffer from overcapacity, redundancy, and built-in inefficiencies. Thus, like the EC, the IEPG seeks to rationalize the European defense industry to be more competitive with the United States in the world arms market.

Table 1.1: Defense and Trade Organizations

| Countries | NATO | IEPG | EC | COCOM^a |
|-----------------------------|-------------|-------------|-----------|--------------------------|
| Belgium | X | X | X | X |
| Denmark | X | X | X | X |
| France ^b | X | X | X | X |
| Federal Republic of Germany | X | X | X | X |
| Greece | X | X | X | X |
| Iceland | X | c | c | c |
| Italy | X | X | X | X |
| Luxembourg | X | X | X | X |
| Netherlands | X | X | X | X |
| Norway | X | X | c | X |
| Portugal | X | X | X | X |
| Spain | X | X | X | X |
| Turkey | X | X | c | X |
| United Kingdom | X | X | X | X |
| Ireland | c | c | X | c |
| United States | X | c | c | X |
| Canada | X | c | c | X |

^aCoordinating Committee for Multilateral Export Controls. Australia and Japan are also members of COCOM. COCOM evaluates the export of goods in East-West trade in the context of military sensitivity.

^bFrance withdrew its military forces from NATO in 1966 but is still considered a participant.

^cNot a member.

Defense Trade Under Reciprocal Procurement Agreements

The United States conducts defense trade with each of the IEPG member states under the terms of reciprocal procurement memorandums of understanding (MOU). These agreements were designed in the late 1970s to promote rationalization, standardization, and interoperability of defense equipment within NATO. At that time, the MOUs were also intended to reduce the large defense trade advantage the United States had over its European allies. It has been generally acknowledged that the U.S. advantage has declined markedly since the first agreements were signed in 1978. The Department of Defense's (DOD) Office of Foreign Contracting monitors the level of two-way defense procurement activity under these agreements.

U.S. Government Agencies Involved in Monitoring EC 92

The U.S. Trade Representative chairs an interagency task force that monitors the civilian aspects of EC 92. The task force has been mandated to ensure that the work of the various departments and agencies involved in international trade issues corresponds to the administration's overall strategy to protect U.S. trade interests. The task force monitors developments and prepares unified, coordinated U.S. positions on emerging EC issues.

State and DOD participate in certain working groups on the task force, but defense trade, cooperation, and security issues are not included in the interagency process or scope. Numerous offices and agencies within the Departments of State and Defense are concerned with those segments of the EC 92 integration process and the parallel IEPG initiatives that fall within their individual scopes of interest. As the head of the interagency working group on standards, the Department of Commerce monitors product standards being developed in Europe that can affect dual-use and military items.

EC Rules: Potential Effects on Defense Trade and Cooperation

In addition to a June 1988 defense tariff proposal, a number of other EC initiatives, primarily related to civilian activities, could affect U.S. defense trade and cooperation. While the defense tariff proposal, which would likely affect U.S. defense subcontractors, remains dormant, other EC rules and initiatives (with implications for U.S. defense trade) are in place or being considered. For example, under certain conditions EC rules-of-origin requirements can affect certain U.S. military equipment and items and result in additional tariffs. European product and other standards being developed could affect parts and components used in military equipment. In addition, the way in which EC merger and acquisition rules are being applied is allowing large European defense conglomerates to form. While the European Commission is deferring for now to the Coordinating Committee for Multilateral Export Controls (COCOM) on handling technology transfer matters for the EC, it may take a more activist role if significant delays are encountered in resolving the issues. Finally, the Commission is considering an EC-wide rule that would directly challenge reexport controls in U.S. legislation and licensing processes.

Dormant Defense Tariff Proposal, if Enacted, Would Likely Affect Dual-Use Items and Parts

To date, the European Commission initiative most directly affecting defense trade is the June 1988 proposal to limit the member states' ability to waive customs duties on selected military imports from non-EC countries. Article 223 of the Treaty of Rome currently limits member countries' imports to a defined list of arms, munitions, and war materials that are exempt from duties (see app. III for list). However, because the member states did not apply tariffs uniformly, the Commission sought to create a uniform defense tariff regime for EC 92. The Commission estimated it would gain an additional \$220 million a year in revenue with a harmonized defense tariff regime. The tariff proposal was also designed to help European defense industries compete on even terms with major defense suppliers, such as those of the United States.

According to U.S. government officials, the tariff proposal introduces unnecessary rigidity into the current system and would be detrimental to U.S.-European security cooperation. The following are key concerns: (1) changing requirements and technology would quickly make whatever list is finally compiled outdated; (2) because duties are paid from the budgets of ministries of defense, the Europeans' purchasing power for defense would be reduced; (3) a duty list could potentially restrict the duty-free entry of dual-use items,¹ which comprise an

¹Dual-use items are those which are not inherently military but are used in military equipment.

increasingly large percentage of defense equipment; and (4) a duty on U.S. exports would heighten trade and burden sharing concerns in Congress.

U.S. government officials and industry representatives agreed that dual-use items and spare parts and components for defense equipment are most vulnerable to a tariff regime. According to the Electronics Industry Association, 80 percent of defense components can also be used in civilian goods. Industry representatives told us that if the Commission were to levy and enforce a tariff² on a dual-use item or part, that item might no longer be price competitive with a European industry product. U.S. prime contractors stated that they expect no resultant difficulty from the tariff proposal, since they manufacture end items exclusively for military use. However, both U.S. government officials and U.S. prime contractors stated that U.S. defense subcontractors and parts suppliers would be particularly vulnerable to the proposed tariff.

According to U.S. government reporting and European officials, the member states disagreed about the form and content of a list of duty-free items. The Commission settled on an exemption list of exclusively military-use items but could not agree on a definition or list for dual-use items. U.S. and European government observers of the process reported that member states presented long lists of dual-use items they wanted included on the exemption list. The Commission disagreed with this approach, more narrowly interpreted article 223, and continued to maintain that dual-use items should be subject to tariffs.

Our examination of three separate draft lists considered by the Commission since the original tariff proposal showed that a progressively longer list of duty-free items was being composed. The dual-use category expanded over time, and the most recent version allowed duty exemptions for items incorporated into, or used for, the construction, repair, maintenance, or modification of military end items. Essentially, this would permit ministries of defense to certify that imported parts and components were being used for military purposes and exempt them from duties—a concept the United States supports. While the original proposal called for a 3-year trial period, according to U.S. government reporting, recent discussions indicated a longer expiration period was being considered.

²Tariff rates vary depending on the item being imported and range between 2 and 10 percent.

The EC committee has not taken action on the tariff proposal since January 1990. According to ministry of defense officials from two NATO countries, opposition from the United States and Canada helped influence the Commission to modify its original proposal. A Commission official told us that the European Commission is no longer promoting the proposal, since its fiscal position is fairly strong and it does not need the additional revenues a harmonized tariff regime would bring. In April 1990, a high-ranking Commission official noted that the Commission was no longer actively considering the proposal. Information we obtained confirmed that the proposal is likely to remain dormant for an unspecified period of time. Member states' practices in applying the current defense tariff list, their relationships to bilateral procurement agreements with the United States, and their implications for U.S. defense trade are discussed in chapter 4.

Rules-of-Origin Requirements Can Result in Duties on Defense Items

Rules of origin³ are used to determine the country of origin of goods being traded. They are further used to assess tariffs and duties, administer trade quotas and sanctions such as antidumping duties, implement preferential trade areas, and apply preferential treatment in government procurement. U.S. government officials and industry representatives have expressed concern that certain U.S. defense items imported into Europe will be subject to the Commission's rules of origin. Procedural ambiguities, combined with the apparent EC emphasis on high technology and electronics industries, have led some U.S. observers to suspect that the EC is using the rules as instruments of protectionist trade policy. They are concerned that, with wide discretion to apply rules of origin on a product-by-product basis, the Commission could yield to political pressure to protect these critical industries.

According to a Commission official, rules-of-origin requirements generally take on meaning only when combined with the applicable import regime for an item. For example, a European customs official would first determine if an import was on a tariff or an antidumping duty list. If the item was on a country-specific tariff or antidumping duty list, the customs official would then determine the item's origin, which in some cases might involve determining the origin of its internal components. Military items listed in article 223, section 1(b), of the Treaty of Rome

³Rules of origin and related EC trade matters are also discussed in our prior report European Single Market: Issues of Concern to U.S. Exporters (GAO/NSIAD-90-60, Feb. 1990).

are exempt from tariffs, and rules-of-origin requirements would therefore not be applied. However, any dual-use items, spare parts, or components that are subject to tariffs are also potentially subject to the rules of origin. The Commission's final decision on the tariff proposal would take on additional importance when combined with rules-of-origin requirements.

The EC currently levies antidumping duties on printed circuit board assemblies of Japanese origin. However, if Japanese printed circuit board assemblies were incorporated into an exempted military end item being imported into the EC, the Commission would not assess a duty on the circuit boards. For example, if a Japanese printed circuit board were incorporated into a U.S. missile system, that system should not be subject to an antidumping tariff because missiles are exempt from tariffs under article 223 of the Treaty of Rome.

Typically, the EC rules confer an import's origin on the country in which the last substantial transformation took place. For example, military command, control, and communications end items are not specifically exempt from tariffs under the Treaty of Rome, and duties may therefore apply. If the end item were to become subject to antidumping duties when of Japanese origin, then a customs official would determine the origin of the end item. If the end item were manufactured in the United States but contained Japanese parts and components, it might be determined that the item was of Japanese origin. This would be the case if the U.S. work share on the end item was not considered to have constituted a substantial transformation of the Japanese parts and components it contained. As a result, both the EC tariff and an antidumping duty would be applied to the end item.

European Standards Could Affect Dual-Use Items

In general, standards are voluntary technical specifications that are approved by a standard-setting body. Both the United States and the EC have promoted health, safety, and environmental standards. The EC member states have national standard-setting bodies that belong to both international and Europe-wide standard-setting bodies. For EC-regulated products, the EC specifies essential requirements that products must meet, and the European standard-setting bodies develop detailed standards to ensure that products meet those requirements. In the United States, standards are developed by many different organizations, one of which is also a member of international standard-setting bodies.

U.S. government officials and industry representatives have raised concerns that European standards activities may be used to protect certain industries from U.S. imports. Any EC standards actions that raise production costs would place U.S. industry at a competitive disadvantage.

According to a Commission official, the EC will not impose defense equipment standards on NATO countries, or diverge from or infringe on NATO standardization activities. He stated that while the Commission could legally devise standards for defense items,⁴ it would be unnecessary and politically inappropriate to do so. In addition, according to DOD standards experts, European NATO standards representatives also participate in Europe-wide standard-making bodies. DOD experts believe that these representatives will advocate standards that generally coincide with accepted NATO standards.

U.S. government officials and industry representatives have not identified European standards that had discriminated against U.S.-manufactured dual-use items or placed U.S. manufacturers at a competitive disadvantage. Nevertheless, dual-use items are subject to ongoing European standards activities. A standard written for a product used for general commercial and industrial applications could also be applied to the product if it is used for defense applications. According to DOD standards experts, European initiatives on standardization could be applied to dual-use items selected for defense purposes in the areas of industrial process, communication systems, medicine, environmental hazards control, product handling, and operational safety. Therefore, continued U.S. monitoring of proposed European product standards is necessary.

Application of Merger and Acquisition Regulation Allows Large European Defense Conglomerates to Form

In December 1989 the Commission issued a regulation, effective September 1990, authorizing the Commission to prohibit mergers, acquisitions, joint ventures, and related transactions (concentrations) of a "community dimension" that would affect competition in the EC. The Commission can approve, deny, and attach binding conditions to proposed mergers and acquisitions. The Commission's goal is to establish a system ensuring that competition in the common market is not distorted. The regulation covers mergers and acquisitions in which the aggregate worldwide turnover of all the undertakings concerned is more than 5 billion European Currency Units,⁵ or about \$6 billion.

⁴Some analysts believe that article 223 of the Treaty of Rome precludes the Commission from dealing with any defense-related matters, including standards.

⁵As of May 1990, one European Currency Unit equaled \$1.22.

The regulation states that its application is without prejudice to article 223 of the Treaty of Rome and does not prevent the member states from taking measures to protect legitimate interests. According to a Commission official, under this provision, an individual member state may block a merger or acquisition if it determines its national security interests are at stake, even if the Commission ruled in favor of it.

U.S. industry has raised concerns that the regulation might be used to discriminate against U.S. industry's acquisition of European firms. The U.S. aerospace industry, for example, is particularly concerned that the Commission will use the regulation to enhance Europe's collective aerospace capabilities by blocking or discouraging any future significant U.S. collaboration with or acquisition of European aerospace companies. U.S. government officials and industry representatives we met with, however, could cite no cases in which a U.S. firm had been denied or blocked in an attempt to merge with or acquire a European firm.

Nevertheless, the way the regulation is being applied allows larger European defense conglomerates to be formed. According to a Commission official, the Commission will review mergers and acquisitions in the arms industry on the basis of the global marketing position of the companies. The Commission takes the view that certain markets—such as supercomputers and weapons—are global in character. For example, the Commission decided that in the context of the global marketplace, the merger of Daimler-Benz and Messerschmitt-Boelkow-Blohm should be permitted. The Commission similarly reviewed and approved GEC's takeover of Plessey in the United Kingdom.⁶

In addition to Commission review, member states still retain the right to review mergers and acquisitions within their borders. Recent examples suggest that member states are also allowing the formation of large defense companies. According to the U.S. Embassy in Bonn, when reviewing the Daimler-Benz merger with Messerschmitt-Boelkow-Blohm, the German government decided that though the merger was monopolistic in the national context, when viewed in the world context, it was not. The United Kingdom recently declined to refer GEC's acquisition of Ferranti Defense Systems to its Monopolies and Merger Commission.

⁶According to a Commission official, in the case of the Daimler-Benz/Messerschmitt-Boelkow-Blohm merger, the parties asked the Commission to review the proposed merger, since the Commission will have the power to revoke the merger under the new regulation. In the case of the GEC-Plessey merger, the Commission reviewed the transaction under existing EC competition law.

Although the government acknowledged that the merger raised competition concerns, it was determined that the public interest would be better served if the merger was not reviewed.

According to a number of studies and U.S. government reports, European defense industries are aggressively positioning themselves to compete in the global arms market through mergers, acquisitions, and joint ventures. For example, the guided-weapons divisions of British Aerospace and Thomson CSF formed a joint venture company called Eurodynamics, creating the largest missile company in Europe. The merger of GEC and Plessey has reportedly resulted in the largest defense company in Great Britain. Thomson CSF has purchased the core of the defense industries of the Dutch multinational corporation Philips. European firms are entering into business relationships from which to compete with U.S. industry. For a further discussion of the emerging European defense industrial landscape, see chapter 3.

For Now, EC Defers to Coordinating Committee for Multilateral Export Controls on Technology Transfers

As part of the single market program, the European Commission intends to eliminate internal border controls. Although the Commission has traditionally left technology transfer and export control issues to its members, it is seeking a more unified approach as the EC moves toward the single market in 1992. U.S. government officials have expressed concern that the Commission may institute policies that rescind, or at least standardize, export controls between member states and try to set an external standard for transfers to third-country markets. Because of varying export controls among the member states, there is fear that sensitive technologies could easily be transferred within and then outside the EC without adequate control. A DOD official noted that the EC's export control regime is no stronger than its weakest link.

U.S.-Europe Bilateral Agreements on Technology Transfer and Export Controls

U.S. technology transfer policy is partly based on formal agreements with countries regarding the protection and reexport of data and products to third countries. Currently, each European country has its own export control policy. When negotiating an agreement and releasing U.S. technologies, U.S. officials consider whether a country has a good record of adhering to past agreements and whether it is a member of the Coordinating Committee for Multilateral Export Controls (COCOM).

U.S. and European observers stated that the Commission would like to take a more active role in export control and technology transfer restrictions. Twice during 1989, Commission President Jacques Delors publicly

stated that the Commission would harmonize export controls. According to a Commission official, the member states agreed in principle that the EC needs a uniform export control policy with uniform minimum enforcement standards. However, the member states were reluctant to let the Commission take the lead.

The issue of EC export controls is now being discussed in COCOM, with U.S. involvement. Through COCOM, the United States, Canada, and the European countries are considering forming a license-free zone with uniform enforcement standards. The shift to COCOM is seen by a Commission official as a move against Commission activism. According to a Commission official, the Commission is delaying taking initiative in this area for the near term in anticipation that the member states will devise a regime in the COCOM forum. The official added that since COCOM has no legal enforcement mechanism, some European nations have suggested that the Commission could enforce the rules devised within COCOM.

According to the First Secretary for Legal Affairs at the EC Delegation in Washington, U.S. bilateral agreements with EC member states that protect critical technologies will be honored and remain in force. However, once the EC decides to devise a regime by regulation, the member states would be obligated to renegotiate any incompatible bilateral agreements or provisions. It seems to us that if efforts to resolve the matter within COCOM fail or are significantly delayed, the Commission could intervene and devise within the Community a technology transfer and export control regime without U.S. involvement.

U.S. Re-Export Controls Through Legislation and Licensing Regulations

U.S. officials have also expressed concern that the Commission would devise a rule that would challenge U.S. re-export controls once the EC dropped its internal barriers. According to a Commission official, the EC views U.S. re-export controls stemming from U.S. legislation and licensing regulations differently from those under bilateral agreements. While U.S. bilateral agreements with EC member states will be honored and remain in force, the EC does not consider U.S. legislative and regulatory restrictions in the same category. France and the United Kingdom have national "blocking" statutes that are interpreted to prohibit their companies and citizens from obtaining foreign licensing approval to re-export goods they have imported. According to a Commission official, these statutes were aimed specifically at U.S. legislation that requires re-export licenses. The Commission is currently considering an EC-wide rule with the same prohibition as the French and United Kingdom

“blocking” statutes. If passed, a Commission blocking rule would challenge U.S. re-export controls that are not contained in bilateral agreements or agreed to through COCOM.

The IEPG: Goals, Progress, and Implications for Defense Trade and Cooperation

The IEPG goals include forming a more competitive, integrated European defense market and industry, agreeing on common operational requirements, and promoting more systematic arms cooperation among the member countries. The IEPG is gradually progressing with its action plan—a step-by-step approach for improving cross-border defense contracting and better coordinating defense research and development among its members. The Group faces challenges to implementing its plan and achieving its goals but is looking for practical ways of resolving them. A number of elements of the IEPG's program and plans, if successful, could foster the exclusion of U.S. industry and increased preference for European firms in defense research, development, and procurement.

The IEPG

The IEPG was formed in 1976 with U.S. encouragement to create a stronger European pillar in the NATO alliance. At that time, the IEPG's membership was limited to the European national armaments directors, who are equivalent to the U.S. Undersecretary of Defense for Acquisition. The IEPG was considered relatively inactive until 1984, when its membership was raised to the ministerial level, which is equivalent to the U.S. Secretary of Defense. Since then, the IEPG has evolved into an active NATO European bloc—except for Iceland—in the NATO Conference of National Armaments Directors. The IEPG presents united European positions on matters before the Conference. The IEPG also views itself as handling defense-related aspects of the European integration process not currently or directly managed by the European Commission. According to the U.S. mission to the EC, informal links have been established between the IEPG and the Commission. The United States has no formal observer status in the IEPG.

While the United States continues to support the IEPG and a strong European pillar in the alliance, government and industry officials have raised concerns that IEPG is fostering political pressure and tendencies toward pan-European exclusivity and positions on alliance-wide issues. More specifically, they are concerned about the effects of IEPG's programs, goals, and initiatives—which essentially promote a consolidated European defense industry and market—on the U.S. defense industry's market access and trans-Atlantic defense cooperation.

The IEPG's Goals

The IEPG's goals were principally outlined in the 1986 report Towards a Stronger Europe, the 1988 Action Plan, and several ministerial-level communiques. Essentially, the 1986 report underlined the need for

improving intra-European armaments collaboration and cross-border procurement and creating a more competitive, efficient, and innovative European defense industry compared to that of the United States. The IEPG report further noted that these improvements would eventually place Europe in a stronger position to cooperate in sophisticated development programs with the United States and to introduce European defense products into the U.S. market.

The 1986 report recognized that the European defense market and industry are characterized by national protectionism, overcapacity, duplication, and inefficiencies. In this report, IEPG recommended

- creating a more open, competitive defense market within Europe;
- supporting cross-border mergers of defense industries within Europe to help rationalize and restructure the industry;
- agreeing on common operational requirements and promoting more systematic arms cooperation in both research and development (R&D) and production among European countries; and
- acting to help the less developed defense industrial nations, such as Greece, Portugal and Turkey, improve their technology and industrial bases from within Europe.

This report also recognized the need for *juste retour*—or a fair return for a purchasing country's investment in a weapons program, either in terms of technology or work share. While this concept is similar to that of offsets¹ in foreign military sales, it differs in that it is used in a broader, long-term sense rather than on a project-by-project basis.

The 1988 IEPG Action Plan established a number of concrete steps for implementing some of the 1986 report recommendations. The plan identified steps needed to (1) improve awareness of bidding opportunities and eligible industries among IEPG member nations, (2) make contract award criteria and procedures more compatible among IEPG countries, (3) record and track cross-border contract awards, (4) study the alternative means of achieving *juste retour* without compromising principles of competition, and (5) develop an IEPG R&D plan with a view toward some form of common funding and closer coordination with industry. In its plan, IEPG recognized the need to create a central, permanent administrative structure to help coordinate the recommended actions.

¹The term "offsets" covers a range of commercial compensation practices that foreign governments require U.S. firms to undertake in exchange for weapons sales. Offsets may include coproduction, technology transfer, or countertrade.

IEPG's Organization

IEPG operates without a formal or legal charter, and its decisions and policies are not legally binding on the member states. Some U.S. government analysts considered the lack of a legal charter and binding decisions a weakness in IEPG's effectiveness. Others, however, viewed this as a positive aspect that could contribute to IEPG's success. They noted that the member states are generally more comfortable retaining their sovereignty in the defense industrial and procurement areas while pursuing common European goals and objectives through the informal IEPG structure. Nevertheless, German defense ministry officials told us that Germany is a proponent of an agreement that would make IEPG ministers' decisions binding on the parties. Some analyses indicate that France and the United Kingdom do not support this concept.

IEPG is organized into three panels. Panel I coordinates operational and equipment requirements among the member nations with a view toward identifying potential cooperative projects. Panel II coordinates research and technology matters, and Panel III deals with procedural and economic matters. The panels and working groups within them take the lead in addressing the implementation of various elements of the IEPG Action Plan. For example, Panel II, headed by France, is leading IEPG efforts to establish a more systematic European defense R&D program. Panel III, headed by Germany, is leading the work on *juste retour* matters and cross-border contracting issues and procedures. In 1989, a permanent secretariat of five personnel and a central IEPG office were created and placed in Lisbon, Portugal, to coordinate IEPG activities. Finally, the European Defense Industry Group—a European defense industry association—plays a formal advisory role to the IEPG, similar to that of the NATO Industrial Advisory Group to the Conference of National Armaments Directors. This group has been organized to mirror the structure of the IEPG's panels and working groups.

Progress and Potential Difficulties in Implementing the IEPG's Action Plan

Overall, IEPG has made gradual progress in implementing steps toward improving cross-border defense contracting within Europe. It appeared to be seeking flexible, pragmatic solutions to potentially problematic issues such as *juste retour* and expansion of the developing defense industrial nations' roles without exacerbating overcapacity already in the European defense industry. Whether or not IEPG will succeed in resolving and reconciling the divergent interests among its members is a matter of conjecture.

In 1987, parallel with the IEPG, France and the United Kingdom entered into a bilateral reciprocal purchasing agreement, considered a mode'

the IEPG to follow. The arrangement allows for increased cross-border competitive bidding and contracting opportunities and the elimination of offsets in favor of juste retour. This is a relatively new arrangement, but some limited progress is being made in its implementation.

Efforts to Improve Cross-Border Contracting Are Progressing

IEPG efforts designed to improve cross-border contracting include (1) publishing member states' contract bulletins similar to the U.S. Commerce Business Daily, (2) designating focal points in each country's defense procurement agency, (3) registering eligible bidders from each country, (4) devising a recording system for cross-border contract awards, and (5) establishing compatible contract award criteria.

Contract Bulletins

At the time of our fieldwork, all countries but Portugal, Greece, Spain, and Luxembourg had published contract bulletins. The bulletins are to contain all procurements, including development, production, repair, and maintenance of defense materials, worth 1 million European Currency Units (\$1.2 million) or more. The bulletins exclude research contracts, nuclear projects, warships, international programs, and certain other programs. Additional exemptions are permitted, but they are expected to be kept to a minimum and are to be reported by the national governments to the IEPG secretariat with the reasons for exclusion from competitive bidding. The intent is to reduce the list of excluded projects over time.

While European defense representatives recognized that the contract bulletins were only a first step, they noted that publication of the bulletins was a significant accomplishment, since several of the countries had never published bid opportunities before. They also told us that these bulletins would be publicly available. However, U.S. government and industry officials noted that if a firm first learns of an opportunity in the contract bulletins, it is already too late to realistically compete for a large prime contract in Europe, particularly if a European company or consortium has already worked on the research contract.

Lists of Qualified Bidders

During our review, each member state was preparing its list of national companies that would be qualified to bid on contracts throughout the IEPG. According to IEPG officials, each nation's list would be exchanged with and automatically accepted by the other IEPG nations. U.S. companies that had met the qualifications criteria and sold directly to the German Ministry of Defense over the past 3 years would also be included on the list. Although the lists will not be published, an individual company can determine its status on the bidder's list.

Recording System for Cross-Border Contracts

According to German defense ministry officials, IEPG's Panel III developed procedures for reporting cross-border contract awards. Each country's defense ministry is expected to record both prime contracts and subcontracts awarded to foreign firms and send the information to the IEPG secretariat. The secretariat will then compile an overall survey for the armaments directors. At the time of our review, the IEPG was gathering statistics on 1988 defense contracts to establish a baseline for recording cross-border contract awards. IEPG was attempting to compile this data by the end of 1990 to evaluate intra-European defense trade imbalances by mid-1991.

Focal Points

According to IEPG officials, all member states had appointed focal points in their respective defense ministries, and all were functioning. The focal points register qualified companies for bidding opportunities, provide advice to foreign and domestic industry on procurement opportunities, and record and report on cross-border contract awards to the IEPG secretariat.

Contract Award Criteria

The IEPG members have agreed that, while national contracting procedures will remain in place, contract awards will be based on "the most economic offer," regardless of the bidder's country. IEPG officials have further defined the criteria to include not only price and fulfillment of technical specifications but also (1) conditions to ensure maintenance and strengthening of the European technology and industrial base, (2) aspects of juste retour, (3) technology transfers and the interests of countries with developing defense industries, and (4) life-cycle costs.

Issues of Juste Retour and the Developing Defense Industrial Countries

Both U.S. analysts of the IEPG and European defense representatives considered juste retour and the developing defense industrial countries among the most divisive and difficult issues to resolve and reconcile with IEPG's stated support for competitive principles and a stronger, leaner European defense industry. IEPG is attempting to formulate practical and flexible ways of resolving these problems. Whether or not it will succeed is speculative.

Juste Retour

The European defense market is largely dominated by suppliers from France, Germany, the United Kingdom, and, to a limited extent, Italy. The countries with smaller or virtually no defense industries, such as Belgium and Denmark, have been concerned that great imbalances in defense trade will seriously disadvantage them in a purely competitive European defense marketplace. This would continue to be the case with increased cross-border subcontracting from the smaller suppliers.

As a result, IEPG's goal of eliminating inefficient project-by-project off-sets among the member countries in favor of juste retour is at risk.

In February 1990, the IEPG stated that "work would continue on improving and implementing a pragmatic and flexible system of juste retour through concrete, transitional measures." European defense ministry and industry representatives confirmed that practical options for implementing juste retour are being considered and discussed. For example, Belgian and Danish defense officials suggested that serious imbalances in defense trade might be addressed bilaterally through increased civilian trade. A key European defense industry representative indicated that industry might also have a role in devising and implementing practical, cost-effective ways to address the imbalances over the longer term. Nevertheless, skepticism persists about IEPG's ability to completely eliminate offsets among the European countries in favor of juste retour.

Developing Defense Industrial Countries' Needs

Countries with developing defense industries, such as Greece, Portugal, and Turkey, are concerned about the effect of fully opening their markets to competitive cross-border contracting without project-by-project offsets and the effect of the IEPG defense market principles on their industries' technological advancement. Those with developing defense industries are also most concerned about the European defense market's being dominated by the three or four most advanced defense industrial countries. At the same time, the more advanced countries are concerned about creating additional overcapacity in the European defense industry in these countries.

In June 1989 and February 1990, the IEPG defense ministers committed themselves to finding practical ways of assisting the developing defense industrial countries. In February 1990, they announced that these countries would have increased bidding opportunities but recognized their need for a transition period before fully opening their borders to competition. According to some European defense ministry and industry officials, industry should play a key role in determining the areas in which the developing defense industrial countries could specialize and contribute to the market and industrial base most competitively.

The United Kingdom- France Reciprocal Purchasing Arrangement

In 1987, France and the United Kingdom entered into a reciprocal purchasing agreement because their armed forces had similar requirements. They were interested in promoting competition among their contractors and reducing redundancy in production. The arrangement

embodies many of IEPG's concepts and principles. For example, project-by-project offsets are no longer required, and a joint committee meets four times annually to discuss potential future procurements, ensure that cross-border bidding and contract awards are fair and open, and hear complaints of unfair treatment. A number of conferences have also been held with prime contractors and subcontractors from both countries, and the two countries are monitoring contract awards and trade flows down to the subcontractor level.

Defense ministry officials from the United Kingdom noted in February 1990 that the arrangement had yielded only a few new cross-border purchases, although the amount of business done with French industry had doubled in the prior 15 months. Most of the purchases were small items such as ammunition, mortar rounds, radios, and sonar equipment. According to the officials, this arrangement was relatively recent and it would take time for the defense procurement bureaucracies in the two countries to become aware of its possibilities. They further pointed out that the current focus is on subcontracts and small purchases. They noted that major weapons programs have long gestation periods, so it is too early to judge the overall effectiveness of the arrangement. They also said they were reviewing their offset policies toward IEPG nations along the lines of the United Kingdom-France arrangement.

IEPG's Defense Research and Development Program and the Question of U.S. Participation

At the IEPG meeting in June 1989, the defense ministers approved a coordinated defense R&D initiative called EUCLID—European Cooperation for the Long-term in Defense. IEPG recognized deficiencies in European defense R&D spending: Europe spends far less than the United States on military R&D, and individual nations duplicate efforts. In earlier European cooperative R&D efforts, inadequate planning, funding, and shortcomings of the legal and administrative framework were cited as causes for failure. In designing EUCLID, the IEPG is attempting to overcome difficulties in previous collaborative R&D programs and appears to be making progress in resolving earlier problems.

According to European defense ministry and industry officials, EUCLID—coordinated and planned in the IEPG's Panel II—is divided into 11 technological categories,² several of which coincide with those DOD identifies

²The 11 categories, referred to as Common European Priority Areas, are (1) modern radar technology, (2) microelectronics, (3) composite structures, (4) modular avionics, (5) electric gun, (6) special intelligence, (7) signature manipulation, (8) opto-electronic devices, (9) satellite surveillance technologies (including verification), (10) underwater acoustics, and (11) "human factors," technology for training and simulation.

as U.S. research priorities. Each of the 11 categories is assigned a lead coordinating nation. The IEPG nations are defining specific research and technology projects under each of the 11 categories. Interested defense ministries will then agree on and approve funding for each project.

Through the European Defense Industry Group, European companies have been working closely with the governments to define the broad technological areas and specific projects. At the time of our review, some of the 50 to 55 specific projects were not as well defined as others. For example, according to German defense ministry officials, projects on "human factors" and simulation were not as well defined as those in the microelectronics and composite structures categories.

In June 1989, the national armaments directors pledged to set aside about \$146 million³ for the program for 1990, with about \$183 million in matching funds expected from industry. The stated goal is to obtain an annual maximum funding level of about \$610 million in the next 5 years. European representatives stressed that the monies will not be placed in a common pool but rather will be obligated and spent only by the countries choosing to participate in each specific research and technology project. European defense officials expected specific projects to be approved in the summer of 1990 and some contracts to be awarded by the end of 1990.

Working with industry, the IEPG nations have generally agreed on the legal and administrative framework and funding mechanisms for EUCLID. They are drafting a memorandum of understanding, which was expected to be signed in 1990, to broadly govern the program's operation. Individual research and technology projects will be governed by individual implementing arrangements under the general program agreement.

Four key areas are being covered in the general agreement: (1) intellectual and industrial property rights, (2) users' rights, (3) licensing fees, and (4) funding. According to the February 1990 IEPG ministerial resolution for EUCLID, intellectual property will be owned by those generating it but will be made available to participating nations to use for their own defense purposes, subject to conditions defined in the general agreement. Provisions for patents and payments of fees are being worked out in close consultation with the European Defense Industry Group. In

³This is the U.S. dollar figure using the May 1990 exchange rate of \$1.22 to 1 European Currency Unit.

addition, equal government funding will be provided by the nations participating in specific projects, unless another breakdown is agreed on, especially to facilitate participation of developing defense industrial countries. Also, nations will pay for their own work shares on each research project.

Administratively, each research project will be managed by a lead nation on behalf of the participating nations. The lead nation will award the prime contract to a single prime contractor, using its own contract rules, amended to ensure the rights of the other participants in accordance with the general program agreement. The prime contractor will then let subcontracts to the other participants' companies and laboratories.

We obtained information and views on the potential for U.S. participation in EUCLID and the form such participation might take. Some European defense officials told us categorically that the United States could not participate in EUCLID, while others noted the possible exception of avionics research projects. Still others indicated that U.S. firms might play a subcontracting role in certain research projects, although it was unclear how that role would be funded under the framework currently envisioned. U.S. government and industry sources were uncertain about a U.S. role, particularly in light of U.S. technology transfer restrictions.

European Defense Industry's Consolidation Leads Market Integration Efforts

While IEPG and its member governments appear to be making slow, gradual progress, the European defense industry has been actively consolidating and restructuring through national and cross-border mergers, acquisitions, joint ventures, and consortia. U.S. government and industry analyses agree that European defense industries are reacting to the integrated market plan, anticipated tighter defense budgets, and tougher competition in the global defense market through an increasing number of these types of transactions. In fact, the shape of the European defense industry has changed markedly over the past 5 years, and further changes will occur in the coming years. A number of U.S. government and private sector analyses indicate that the European defense industry is emerging with the largest French, British, and German companies at the core of the sector, along with those from Italy. The trend is clearest in defense aerospace and electronics.

Defense Industry Restructuring Within National Borders

Key British, French, and German defense firms have been actively restructuring within their national borders. For example, according to the Center for Strategic and International Studies, in the United Kingdom, between mid-1986 and 1988, 24 mergers occurred among defense firms. In France, Thomson CSF and Aerospatiale have formed a new company, Sextant Avionique, regrouping and merging their avionics and flight electronics activities. In Germany, Daimler-Benz merged with Messerschmitt-Boelkow-Blohm to form a conglomerate that controls more than 50 percent of Germany's defense business, including Dornier (aircraft and missiles) and AEG (electronics). Dornier, Motoren und Turbinen Union (engines), Messerschmitt-Boelkow-Blohm (aircraft and missiles), and Deutsche Airbus joined to form one company—Deutsche Aerospace. Deutsche Aerospace is also held by Daimler-Benz.

Defense Industry Restructuring Across Borders

Cross-border mergers, acquisitions, joint venture companies, and numerous consortia formations have also been increasing among European defense companies. For example, in 1989, a GEC (United Kingdom) and Siemens (Germany) joint venture acquired Plessey (United Kingdom) and will split Plessey's defense avionics, antisubmarine warfare, radar, and communications business between the buyers. In connection with the European Fighter Aircraft, GEC acquired the radar business of Ferranti (Italy). Thomson CSF (France) acquired Philips' (Netherlands) defense business. British Aerospace and Thomson CSF formed a joint venture—Eurodynamics—pooling their missile business and resources. Aerospatiale (France) and Messerschmitt-Boelkow-Blohm (Germany) were moving to form a joint-venture company with their helicopter divisions at the time of our review. According to the U.S. embassy, Brussels, French aerospace companies have bought controlling interests in Belgian firms: Dassault has bought controlling interest in SABCA, the company that has performed on F-16 contracts, and SNECMA has purchased controlling interest in the engine division of Fabrique Nacional Moteurs.

Among the numerous European industrial consortia being formed are Euroflag (aircraft companies from Italy, France, the United Kingdom, Spain, and Germany), which responds to the IEPG's defined requirement for a new tactical transport, and Eurosam (missile companies from France and Italy), which is to develop, produce, and market three types of surface-to-air missiles to replace the U.S. HAWK systems.

If Successful, IEPG Efforts Could Foster More European Preference in Defense Research, Development, and Procurement

There is a wide range of views on whether or not the IEPG will be able to overcome numerous challenges in achieving its goals. Strong national preferences in defense procurement and IEPG's lack of legally binding rules and charter work against cross-border contracting initiatives. Also, difficulties in implementing *juste retour* and developing the defense industries of certain countries work against retaining the commitments and interests of certain IEPG members. Some observers of IEPG have also pointed out that the IEPG has not had many past successes.

Based on our review and discussions with defense officials from several involved countries, it is unclear whether or not these challenges will be insurmountable for the IEPG countries. As the defense industry becomes more European than national, business from contracts is likely to spread naturally across borders. As the IEPG countries record and report their cross-border contract awards through the IEPG secretariat, natural pressures could build to increase the numbers. As budgets tighten, pressures could further build to make collaborative projects work better than in the past, as single nations can no longer afford strictly national systems.

If successful, certain elements of IEPG's initiatives could foster more European preference in defense research, development, and procurement and work against a U.S. role in future programs and contract awards. For example, recording and reporting cross-border contract awards automatically creates some political pressure to buy European equipment over U.S. equipment. As one U.S. official pointed out, the IEPG members would not get any credit for buying American equipment. In connection with the United Kingdom-France bilateral purchasing agreement, which also tracks cross-border contract awards, a United Kingdom defense official told us that if all things were equal between French and U.S. firms' bids on a contract, the French firm would probably be selected. Furthermore, while IEPG is working to eliminate offsets among the member nations in an evolutionary fashion, the member nations will continue to impose them on outside competitors. As a result of these IEPG actions, for example, the United Kingdom defense ministry is reviewing its offset policy with the view toward ending project-by-project offsets for its IEPG partners. Nevertheless, we were told that the United Kingdom will continue to "invite" U.S. contractors to provide offsets.

If the EUCLID research and development program is successful and does not include a role for the United States or its companies, a U.S. role in potential trans-Atlantic codevelopment programs and follow-on production is also in question. Nevertheless, European defense officials noted that while European weapons cooperation was likely to improve and

increase, some continued cooperation with the United States would be politically and technologically important. They further noted that in the long term, if successful, the IEPG initiatives would place Europe in a better position to become a "more equal" partner in programs with the United States.

Finally, IEPG's goal of creating an integrated defense market supports and complements the defense industry's restructuring activities. The two movements combine to form a potentially more competitive European defense market and industry. In the coming years, the U.S. defense industry will be competing in a European market characterized by stronger European intergovernmental and industrial links.

Reciprocal Procurement MOUs With IEPG Countries and Defense Trade Activities

During the late 1970s, the United States entered into reciprocal defense procurement MOUs with 12 of the 13 IEPG member countries with the intention of reducing the significant U.S. defense trade advantage and promoting a two-way street in defense trade. These agreements were also designed to promote rationalization, standardization, and interoperability of defense equipment within NATO. The MOUs do not specifically obligate reciprocal treatment (in terms of waivers of tariffs or other restrictions) or access to signatories' defense markets. Certain IEPG member countries have been levying tariffs on U.S. defense equipment they import and considering the tariffs when evaluating U.S. contractors' bids. Since EC countries eliminated customs duties among themselves, U.S. firms could be placed at a competitive disadvantage with bidders from EC countries.

The U.S. defense trade advantage over the IEPG countries has significantly declined since the reciprocal defense procurement MOUs were initially negotiated. Although there are serious weaknesses in the data and the methods for analyzing it, alternative estimates based on the best available data show that the MOUs have served the intended purpose of substantially reducing the U.S. defense trade advantage over those countries. This development and the changing arms trade environment have caused some observers to question the continued usefulness of the MOUs in their present form.

MOU Objectives: Grant Reciprocal Access to Defense Markets and Promote Allied Armaments Cooperation

First authorized in 1977, the bilateral MOUs reflect the priority of the late 1970s and early 1980s: reduce the significant defense trade imbalance in favor of the United States and underpin armaments cooperation. While the MOUs also ostensibly ensured equal U.S. access to European defense markets, that was not a principal consideration when they were negotiated because the U.S. defense trade advantage was then almost 8 to 1, according to one DOD estimate. Rather, the emphasis was on reducing the imbalance and ensuring a two-way street in defense trade. The United States has signed MOUs with 12 of the 13 IEPG countries, excluding Greece.¹ The original agreements ranged in duration from 5 years in the case of Turkey to 10 years for most of the other countries.

¹The 1986 Defense Industrial Cooperative Agreement between the United States and Greece includes provisions similar to some of those found in the MOUs with the other IEPG countries.

Reciprocal MOUs: Obligations and Practice

According to DOD and the Commerce Department, the MOUs call for the waiver of buy-national restrictions and duties to allow the signatories' contractors to participate competitively in the defense procurements of the other country. In addition, if tariffs or duties are applied, the MOUs obligate the signatories to weigh bids from each other's contractors without considering the costs of the duties. However, the MOUs with the IEPG member nations allow the signatories to waive buy-national restrictions and duties and weigh bids without considering duties, only to the extent that it is consistent with national laws and regulations (emphasis added). Because of this escape clause, DOD's General Counsel (International) concluded that the signatories were not specifically obligated to waive duties and buy-national laws if the waiver conflicted with national laws and regulations. We agreed with this interpretation.

From the European perspective, a European Commission attorney told us that the proposed EC defense tariff regime (see ch. 1) would not conflict with the MOU provisions because the MOUs do not specifically require the signatories to waive tariffs if doing so would not be consistent with national laws and regulations. In addition, DOD's General Counsel (International) pointed out that the escape clause also applies to the United States. In fact, Congress passed legislation in November 1989 to limit DOD's authority to waive U.S. buy-national restrictions.²

In practice, for DOD procurements of products originating in the countries with which we have signed agreements, the United States complies with the MOUs by waiving U.S. buy-national restrictions and customs duties. However, DOD has not been aware of how European countries were complying with their MOU obligations. For example, a September 1988 cable from the Secretary of Defense to U.S. embassies in the IEPG member countries stated that the United States lacked a complete picture of how our European NATO allies interpret their MOU commitments regarding waivers of defense duties.

European Practices

While they are binding government-to-government agreements, the MOUs have not guaranteed the United States duty-free access to the signatories' defense markets. Three European countries—the Federal Republic of Germany, the Netherlands, and Belgium—currently impose tariffs on

²The National Defense Authorization Act for Fiscal Years 1990 and 1991 (sec. 823) requires that the Secretary of Defense, after consultation with the U.S. Trade Representative, rescind the Secretary's blanket waiver of the Buy American Act for certain products produced in a foreign country that has violated the terms of an MOU by discriminating against certain types of products produced in the United States and covered by the agreement.

U.S. defense goods. In addition, the United Kingdom collects duties on dual-use and nonlethal defense items. According to DOD, France's defense ministry paid tariffs up until February 1988.

The Federal Republic of Germany defense ministry pays tariffs on items not on the original list of exempted equipment in the Treaty of Rome. (See app. III.) Both EC and national tariffs are levied on imported defense items from non-EC countries, but all cooperative programs and/or common defense programs are exempted. More specifically, Germany considers bilateral and NATO cooperative projects as exempt from duty. The Netherlands government paid the EC tariff on most U.S. defense items it has bought. Its procurements of the F-16 fighter and a few other items are exempt from duties. The Belgian government levies duties on all imports except those related to its armored personnel carrier and F-16 programs. The Belgian National Armaments Director estimated that the duty ranges from 5 percent to 10 percent. According to DOD, the United Kingdom waives duty on items on a special list covering most weapons and spare parts. However, according to U.K. defense ministry officials, the ministry does not pay duties on lethal items, but it does pay duties on nonlethal materials.

Representatives from some of these countries would consider it a conflict with the MOUs if U.S. duties were imposed on their defense exports to the United States. For example, the Belgian National Armaments Director believes that the MOU guarantees Belgium duty-free defense exports to the United States. If this waiver were not honored, the government of Belgium would take exception. Furthermore, a British defense ministry official stated that if DOD began paying duties on United Kingdom equipment it imported, it would not be honoring the reciprocal procurement MOU.

As a practical matter, some European officials consider tariffs when evaluating U.S. contractors' bids. We questioned whether a country could evaluate a U.S. bid without considering tariffs or duties because the tariffs could place a U.S. bid out of the competitive range or beyond the procurement budget. According to officials from the Netherlands and Belgian governments, if a tariff makes an otherwise competitive U.S. defense contractor's bid too expensive, practical budget constraints would compel them to at least consider tariffs in weighing bids, or not to select the U.S. item. On the other hand, German government officials stated that, by direction, contracting officers are not allowed to consider tariffs when evaluating bids. They would request additional funds from

Parliament if the tariffs caused the U.S. bid to exceed the budget allocation.

The fact that certain countries impose tariffs on defense equipment purchased from the United States and must consider tariffs when weighing bids takes on additional importance when considering the EC 92 process. Since EC countries eliminated national customs duties among themselves and began applying only common external EC tariffs, U.S. firms could be placed at a competitive disadvantage with bidders from EC countries. This would be the case regardless of the Commission's future action on the defense tariff list discussed in chapter 1.

Estimates of U.S. Defense Trade Advantage Questionable

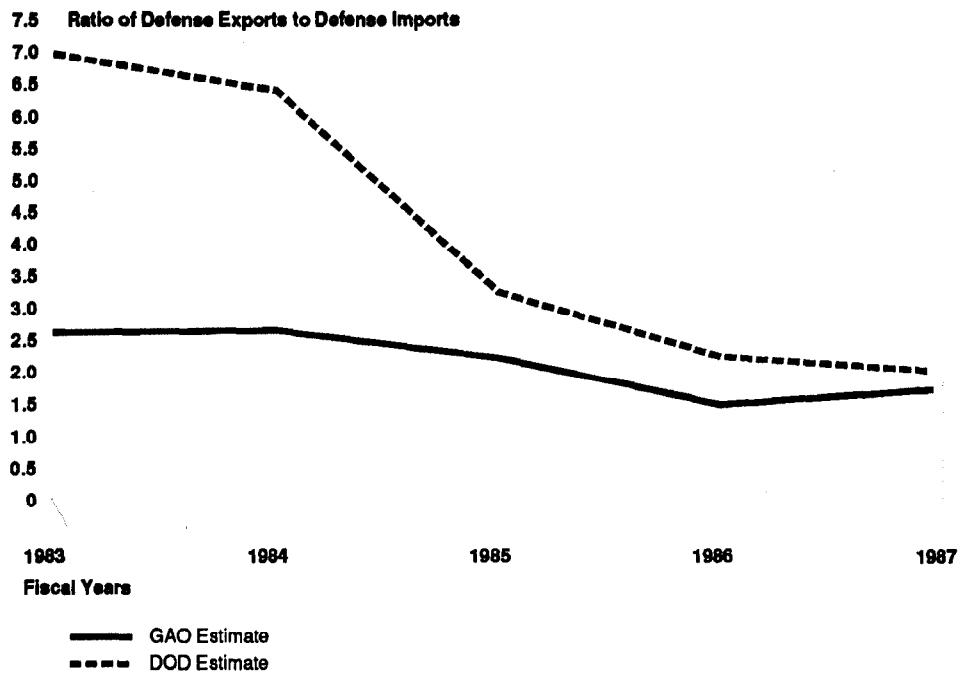
The signatories to the reciprocal procurement MOUs track the activity occurring under the agreements. Since fiscal year 1983, DOD's Office of Foreign Contracting has collected and published data on the annual defense procurement balances between the United States and reciprocal procurement MOU signatories. DOD officials pointed out that DOD figures do not reflect the defense trade balance, but rather the defense procurement balance between the United States and the reciprocal procurement MOU signatories. In part, DOD measures the defense procurement balance by considering contract values rather than actual deliveries and including civilian items purchased. We took an alternative approach, which reflects trade rather than procurement of defense items, to gain better insight into U.S. defense exports to the IEPG nations. For a number of reasons, there is little confidence in the data used to calculate the defense trade or procurement balances.

Alternative Ways of Measuring the Defense Trade Balance

The U.S. defense trade (or procurement) advantage has declined since the late 1970s and early 1980s when one DOD estimate showed the ratio was almost 8 to 1. The decline was most marked between fiscal years 1983 and 1987—the period for which the Office of Foreign Contracting has collected adequate data and has updated the original published figures. However, DOD maintains that the procurement balance remains more favorable to the United States than some observers would suggest. Our alternative analysis of the defense trade numbers for fiscal years 1983-87 shows that while the balance is favorable to the United States, it is not as favorable as DOD's figures suggest.

Figure 4.1 compares DOD's revised estimate of the defense procurement ratio and our estimate of the U.S. defense trade advantage with IEPG member nations.

Figure 4.1: Alternative Estimates of U.S.-IEPG Countries' Defense Trade/Procurement Ratios, Fiscal Years 1983-87

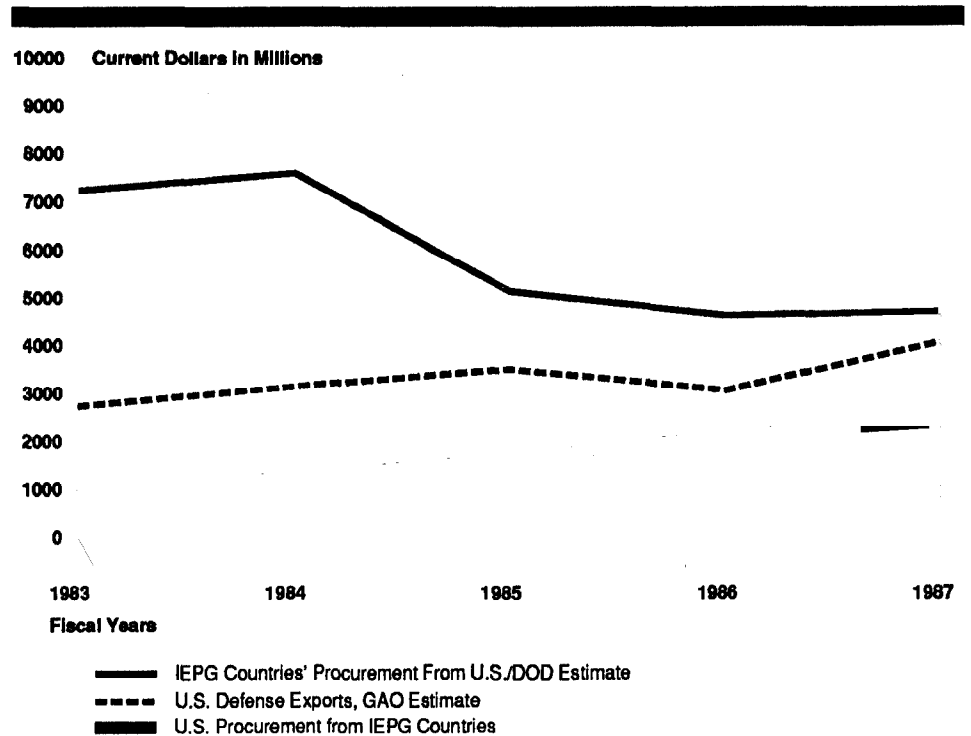


As shown in figure 4.1, DOD estimated that the U.S. defense procurement advantage declined from 6.9 to 1 in fiscal year 1983, to 2 to 1 in fiscal year 1987.³ Our analysis shows that the U.S. defense trade advantage has been lower than DOD's figures would indicate. We estimate that the defense trade ratio fell from 2.6 to 1 in fiscal year 1983 to less than 1.5 to 1 in fiscal year 1986 before showing a slight improvement to 1.7 to 1 in fiscal year 1987. According to our estimate, the decline in the defense trade ratio between fiscal years 1983 and 1986 is less than DOD estimates but is still more than 40 percent. When measured between fiscal years 1983 and 1987, we estimate the decline in the defense trade ratio is still greater than 33 percent.

In figure 4.2, we compare DOD's measurement of the defense procurement balance to our measurement of the defense trade balance in current dollars.

³Data for 1988 is incomplete, but DOD estimates the ratio has increased to slightly above 2 to 1.

Figure 4.2: Alternative Estimates of U.S.-IEPG Countries' Defense Trade/Procurement Dollar Flows, Fiscal Years 1983-87



IEPG countries' procurements reflect defense ministries' purchases

As figure 4.2 indicates, DOD estimates that the U.S. surplus declined from over \$6 billion in fiscal year 1983 to \$2.3 billion in fiscal year 1987, as measured in then-year dollars. We estimate that the U.S. defense trade surplus declined from over \$1.6 billion in fiscal year 1983 to under \$1 billion in fiscal year 1986, before increasing to about \$1.7 billion in fiscal year 1987.

Our analysis of U.S. defense exports to the IEPG member countries shows that between fiscal years 1983 and 1987, commercial munitions deliveries increased when compared to government-to-government foreign military sales (FMS) deliveries. Commercial munitions deliveries increased from 10 percent of total deliveries in fiscal year 1983 to about 40 percent in fiscal year 1987. According to the State Department and other observers, the United States is selling fewer complete or off-the-shelf weapons systems to the IEPG member countries, while the U.S. defense industry is selling more parts and spares to Europe.

Our analysis of European defense procurement budgets shows that while the combined defense procurement spending of the IEPG member countries increased from approximately \$20 billion in 1983 to nearly \$32 billion in 1987, an average of about 14 percent of their defense procurement budgets has been devoted to imports of U.S. defense goods. During that period, the percentages ranged from a high of 18 percent in 1985 to a low of 12 percent in 1986.

Confidence in the Trade Data Is Low

According to DOD and other sources, confidence in the accuracy of the trade balance is low because of weaknesses in the data used to measure defense trade. For fiscal years 1983-86, DOD overstates actual U.S. defense exports to and underestimates U.S. defense purchases from the MOU countries. Also, in some instances DOD negotiated defense procurement ratios with some of the IEPG countries.⁴

For fiscal years 1983-87, DOD used data from four U.S. sources to measure the defense procurement balance. DOD combines commercial munitions delivery data from the State Department's Office of Defense Trade Controls (formerly the Office of Munitions Control) and government-to-government FMS agreement data from the Defense Security Assistance Agency. Using two other sources of data, DOD's Office of Foreign Contracting tracks U.S. purchases from foreign prime contractors and subcontractors. A detailed discussion of the weaknesses inherent in the data is included in appendix I.

For fiscal years 1983-1986 in particular, DOD's defense procurement calculations tend to exceed actual U.S. defense exports or deliveries for two reasons: (1) FMS agreement figures tend to be higher than actual delivery numbers, and (2) DOD's data includes nondefense items purchased with European defense procurement funds.⁵ DOD also tends to understate U.S. defense procurements from the Europeans because information on U.S. purchases from the Europeans does not include all contracts awarded to foreign firms.⁶

DOD has also negotiated defense procurement ratios with the allies. For example, in the case of Italy, for fiscal years 1983 through 1986, the

⁴According to a DOD official, DOD has not negotiated defense procurement ratios since 1988. Since fiscal year 1988, DOD has accepted the other countries' data on their purchases from the United States, and those countries have accepted U.S. figures on purchases from them.

⁵DOD's data on its purchases from Europe also includes dual use items.

⁶The DOD data base excludes certain U.S. defense purchases made overseas, such as construction contracts.

defense procurement ratio DOD originally calculated was also less favorable to the United States than the ratio negotiated with Italy. DOD figures reveal that the ratio, while still favoring the United States, declined from 3.7 to 1 in fiscal year 1983 to 1.3 to 1 in fiscal year 1986. The negotiated ratios show the U.S. advantage declining from 4.7 to 1 to 2.8 to 1 in the same time span. In this case, because of discrepancies in the two countries' data bases, the United States presented its version of the trade data and proposed that the United States would accept Italy's figures for its purchases from the United States and vice versa.

In our analysis of the defense trade balance, we substituted FMS delivery data for FMS agreement data. We believe a relatively valid assessment of MOU defense trade activity can be made using FMS delivery data for three reasons. First, using FMS delivery data is consistent with using the commercial delivery data supplied by State. DOD's Office of Foreign Contracting agrees that delivery data is more accurate in the long run. Second, the export figures do not include trade balance ratios negotiated with certain allies. Third, our use of defense exports excludes nondefense items the European defense ministries purchase from the United States. However, our assessment also has limitations. Appendix I discusses the limitations of DOD's and our data bases in further detail.

Debate Over Continued Utility of MOUs

The future of the MOUs has been debated within DOD in recent years. Prior to the EC defense tariff proposal, the value of continuing the MOUs had already been the subject of some controversy within DOD, especially since the U.S. defense trade advantage had declined markedly since the 1970s. According to some DOD and U.S. defense industry officials, the MOUs have resulted in a one-way street in favor of European defense companies. As previously discussed, the United States provides duty-free access for DOD purchases from the MOU countries, while some European countries impose tariffs on U.S. equipment they import. On the other hand, officials from the Office of Foreign Contracting maintained that the MOUs have granted U.S. producers a degree of access to the European market they otherwise would not have had under other trade agreements.

One DOD study criticized the defense procurement MOUs on a number of points. They lack meaningful reciprocity, they are perhaps inappropriate given the changes in worldwide defense trade patterns, and they were negotiated without reference to an overall strategy. The study asserted that the MOUs should affirm our trade policy and that no MOU

should be entered into without a written expression of the need and the relevant benefits to be gained.

A 1987 DOD review recommended that the MOUs be standardized and renegotiated to emphasize defense cooperation more and defense trade balances less. However, the Director, Office of Foreign Contracting, stated that he would rather persuade the allied nations to add to existing MOUs annexes incorporating principles of the government procurement code. These annexes would include (1) a requirement that U.S. companies be treated the same as national companies, (2) procedures for redressing grievances, and (3) open publication of bids. Four MOUs with IEPG countries are now under year-to-year extension. Barring the administration's decision on future policy towards continued use of these agreements, the Director expected to amend the MOUs with these countries by the end of fiscal year 1990 and extend them another 5 years.

In June 1990, the MOU with France was amended and renewed. In November 1990, MOUs with Italy and the Netherlands were also amended and renewed. These agreements address publication of bids and require the signatories to have procedures for redressing grievances. They do not, however, specifically obligate the signatories to treat each other's companies as they would their own. Nevertheless, all three amended MOUs provide that, upon request, suppliers shall promptly be provided pertinent information on why they were not allowed to participate in a procurement or were not awarded a contract.

Perceptions of Intra-European Preference in Defense Purchases and New Programs

While U.S. government and industry officials perceive increasing intra-European preference and discrimination in defense contract awards, these perceptions are difficult to confirm or prove. It is generally acknowledged that since at least the early 1980s, the European allies have preferred to buy nationally first, then buy European, and finally buy U.S. defense equipment. U.S. government and industry representatives related numerous anecdotal incidents of European defense contract awards influenced by a preference for European firms. Three key factors contributing to this perceived trend are (1) European nations more naturally and easily cooperate among themselves than with the United States, (2) the EC single market processes and IEPG initiatives reinforce pan-European programs and practices, and (3) European political cooperation influences individual countries' decision-making on weapons purchases and new programs. While the U.S. defense budget is likely to decline, the European and other foreign markets will become more important to the U.S. defense industry. However, the likelihood of declining European defense budgets, along with strong European preference, leads U.S. defense contractors to expect that future sales to Europe will consist mainly of parts, support, and weapon system upgrades.

European Preference and Discrimination Are Difficult to Confirm

Although U.S. government and industry officials related numerous instances of perceived European preference and discriminatory practices in defense contract awards, we could not validate these perceptions through documentation. As we noted in a prior report,¹ lack of information about foreign procurement practices makes it difficult to determine whether European countries discriminate in defense procurement and to assess the degree of discrimination. National security concerns create additional information-gathering problems and are often used as a reason to exclude foreign competition. We also reported that it is generally acknowledged that the government's ability to obtain information about foreign government procurement practices has been limited in the past by a lack of expertise and by resource constraints. In addition, the private sector rarely complains, fearing retaliation. The U.S. defense industry similarly fears retaliation.

Moreover, DOD officials noted that European defense procurement policies were generally lacking in transparency or openness. For example,

¹International Procurement: Problems in Identifying Foreign Discrimination Against U.S. Companies (NSIAD-90-127, Apr. 5, 1990).

one U.S. embassy reported that it was very difficult to confirm preference for European firms on defense procurement decisions. When approached, the host country always supported its contract decisions with "paper arguments" that were plausible on the surface. As a result, much of our information on European preference in defense procurement is based on anecdotal and testimonial evidence.

U.S. Embassies and Defense Industry Perceive Increasing Preference for European Firms in Contract Awards and New Programs

Information we obtained indicates that the Europeans have been pursuing a strategy of substituting European defense procurement and production for foreign defense imports at least since the early 1980s. Some industry representatives indicated that the trend began as early as the 1970s. In addition, U.S. embassies and defense industry officials perceive a preference for European firms as a factor in a number of defense contract awards, and the number of pan-European research and development projects seems to have increased. State and DOD officials noted that the European allies exhibit a clear preference to buy nationally first, then buy European, and finally buy American.

According to U.S. defense industry representatives we contacted, the trend in the European defense market is toward the exclusion of U.S. firms, at least from the market for complete weapon systems. While the contractors and defense officials generally believed that neither individual European countries nor the United States could afford to develop weapons alone anymore, some observers believed that the Europeans are attempting to systematically exclude U.S. contractors from future participation in this market and "design out" U.S.-made parts.

The Canadian government has also noted that a preference in awarding contracts to European firms was negatively affecting trans-Atlantic defense trade. In a report on EC 92 and defense, Canada concluded that European countries have consistently favored domestic sources in defense procurements. In addition to maintaining a domestic defense base, European purchases are directed to domestic industry to provide jobs, develop high technologies, and address economic concerns such as balance of payments. Few European countries stress competitive sourcing for defense procurement, and in some countries the majority of defense contracts are negotiated without competition, or bidding is limited to particular, invited firms.

Cases of Perceived Preference in Contract Awards

U.S. embassies and industry representatives have reported on and told us of numerous instances in which real competitive pressures imposed by U.S. defense firms were used by European governments to negotiate reductions in price with European firms. For example, U.S. firms were used as “straw bidders,” or “stalking horses”; that is, a European defense ministry used U.S. firms’ price bids to force local or other European suppliers to lower their prices. They also noted cases of preference in contract awards, despite U.S. firms’ price and quality competitiveness. In other cases, one European government apparently applied political pressure to another, and as a result, European equipment was selected over U.S. equipment, regardless of price, delivery, or quality considerations. One U.S. defense company representative observed that his firm could compete with any company, but it could not compete with a government.

Among the examples provided by U.S. industry representatives were the following:

- A U.S. defense firm with subsidiaries in Europe was asked by a European company to participate on a subcontract for the European Fighter Aircraft project. Although the U.S. company outbid a European competitor on the initial contract, the European Fighter Aircraft group vetoed the U.S. firm’s participation. After the European competitor was brought into the program, the same U.S. firm was asked to submit another bid, apparently to keep the European firm’s bid down.
- One U.S. firm lost a competition for a contract on a European satellite program because of a preference to use European firms, even though it underbid the winning European competitor by tens of millions of dollars.
- A U.S. defense company was told it had won a key subcontract for one European country’s weapon system. The government of a competing European country applied political pressure on the customer to reverse its decision and guaranteed to underwrite the contract against cost overruns to secure the contract. The buyer subsequently reversed itself on the contract award to the U.S. firm.
- One U.S. firm competed for a subcontract on a European helicopter. Its spokesman claimed that, although his firm’s bid was cost competitive, a European head of state intervened with his counterpart in the purchasing country, and the U.S. company lost the contract. A government official in another European country confirmed this account.
- A U.S. firm was initially told by a European defense ministry that it would do the follow-on to a contract it had originally won in that country. Subsequently, the U.S. firm was told by the government that an

American firm would not be awarded the contract. Despite its significant technological advantage, the company was forced to form a consortium with two national firms to participate in the project.

Preference for European Firms Is Perceived as a Factor in New Defense Programs

A preference for European firms was perceived as an important factor in several European defense ministries' decisions on new development programs. These programs were chosen over either U.S. codevelopment programs or pre-existing, fielded U.S. systems that could fill the requirements. In most European countries, the companies chosen for R&D contracts are automatically chosen for the follow-on production contracts. A 1989 State Department memorandum noted that European-only defense projects reflect Western Europe's intent to create or strengthen self-sufficient defense industries. U.S. embassy and industry representatives provided information on a number of such cases, including the following:

- The U.S.-led NATO Anti-air Warfare System program was abandoned by some European participants in part because they favored a European alternative, the French-Italian Family of Anti-aircraft Missile Systems. The United Kingdom withdrew from the NATO project in December 1989, partly because the French government required the United Kingdom to join the French-Italian project before it would approve of a joint venture between the missile divisions of British Aerospace and Thomson-CSF of France. The United Kingdom had already been involved in a related feasibility study with France, Spain, and Italy since at least December 1988.
- The European Fighter Aircraft was cited as a pan-European development program on which the European partners are spending 10 percent of their combined defense procurement budgets. The aircraft duplicates the Hornet 2000 (an advanced version of the U.S. F/A-18), which the U.S. government unsuccessfully offered as a codevelopment option. According to U.S. officials involved in the negotiations, the Request for Proposal was written specifically and purposefully to preclude U.S. competition. For example, they stated it required firms interested in bidding for contracts to have their headquarters located in one of the four European countries involved in the program. Representatives of a U.S. firm competing for subcontracts believed another Request for Proposal requirement—that potential suppliers detail government or other restrictions affecting the re-export of the aircraft's technology to third countries—was used by the European partners to limit the competitiveness of U.S. firms. Furthermore, a U.S. embassy cable noted that the German government used inflated exchange rates to show that the

fighter was the cheapest aircraft compared to an alternative such as the Hornet 2000.

- The Hughes Corporation was involved in a consortium with a German firm to bid on a contract for the design of the European Fighter Aircraft radar against Ferranti, a firm based in the United Kingdom. Despite its generally recognized technological superiority, the United Kingdom did not select the Hughes radar ostensibly because it might not meet its North Sea operational requirements. Although the United States guaranteed a pre-approved export market of 24 countries for the Hughes radar, the United Kingdom obtained the German government's consent to select the Ferranti radar. To do so, the United Kingdom provided an indemnity of \$200 million to ensure against cost overruns incurred in integrating the radar with the fighter. According to a DOD official, the German government estimated that integrating the Ferranti radar with the fighter could cost up to \$300 million more than integrating the Hughes radar.
- Largely for political reasons, the Federal Republic of Germany joined the French in the PAH-II helicopter development project, although the German Army preferred to purchase the U.S. AH-64 Apache helicopter. Previously, a proposed French-German tank project faltered, making the PAH-II project even more politically important. In early 1989, the United Kingdom and the Netherlands also expressed serious interest in joining the Eurocopter PAH-II project.
- The IEPG-sponsored Future Large Aircraft program is being developed to replace the current fleet of large transport aircraft, although some observers noted it would fill the same requirements as the alternative U.S.-led Advanced Tactical Transport project. U.S. firms were not invited to participate in the IEPG program. One U.S. corporation was part of the European industry consortium that did the initial requirements study. The IEPG stated it could not administratively fund this U.S. firm's participation, however. It is unclear whether U.S. firms will be able to participate in the program.

Factors Contributing to Perceived Preference in Defense Procurement

Three main factors contribute to the perceived belief that the Europeans are given preference in defense procurements. First, according to European defense representatives, the European nations find it more natural and easier to cooperate among themselves on defense projects than they do with the United States. Second, the EC single market processes discussed in chapter 2 and IEPG initiatives promote a more unified West European defense industrial base and market and therefore preference for European firms for defense contracts. Third, the politics of cooperation among the European governments contributes toward a preference for European firms in defense purchases and development projects.

European government officials acknowledged an element of preference in their defense procurement decisions. In general, these officials stated that, while trans-Atlantic cooperation would continue to be politically and technologically important in certain areas, it would be easier for them to cooperate within Europe than with the United States. Both U.S. and European observers cited the following reasons that the Europeans find it difficult to cooperate with the United States on defense projects: (1) differing U.S. and European military missions and equipment requirements; (2) weaknesses in the U.S.-led cooperative programs; (3) U.S. controls, such as technology transfer restrictions; and (4) too many partners involved in the projects.

The IEPG initiatives have also given impetus to the trend toward expression of preference for Europeans in defense procurement decisions. IEPG noted in a report that the benefits of a defense procurement policy based on European preference would be "lasting," and stated that "any premium involved in purchasing within Europe rather than elsewhere during the years of transition will in our view be greatly outweighed by the long-term benefits...." A U.S. Ambassador also noted that the European defense ministries have been affected by IEPG concepts and initiatives. He noted that IEPG goals have engendered "a frame of mind" in favor of European equipment, and that is all it takes to influence defense procurement decisions. Many U.S. defense contractors also believed the IEPG initiatives were contributing to the trend towards pan-European preference.

Political considerations are also perceived as contributing to the trend towards the preference for European firms. Defense ministry officials in Europe acknowledged that many procurement decisions are not in the best interest of competition or of getting the best product for the money but that politics will always enter into program and procurement decisions.

Implications for the U.S. Defense Industry

While some contractors and government officials believe that U.S. technological and competitive advantages will help them retain a share of the European market, they expect that fewer new U.S. weapon systems will be purchased. Future sales to Europe will consist mainly of parts, support, and upgrades for existing systems. In their view, sales of off-the-shelf systems will become rare in the future. To offset this trend, U.S. defense companies are considering or trying to enter into joint ventures and teaming arrangements to maintain access to the defense market in Europe.

The likelihood that European defense budgets will decline and the perceived preference for European firms in defense procurement lead some U.S. industry representatives to expect that they will increasingly function as subcontractors in the European defense business. They acknowledged, however, that their firms currently rely on European sales for only a small portion of their total defense sales. Their estimates of this portion ranged between 1 percent and 9 percent. However, with future significant U.S. defense budget cuts, the European market will become more important to U.S. firms' business.

U.S. Monitoring of and Response to European Initiatives Affecting Defense Trade and Cooperation

While an interagency task force was formed in 1988 to coordinate overall executive branch actions on EC 92, it does not have a working group on defense or defense trade issues and does not monitor IEPG activities. Certain task force working groups monitor EC initiatives that have implications for defense trade but are directed toward the civilian market. Defense participates in the working group chaired by Commerce on EC standards. Offices within both State and Defense have recommended improved internal and interagency coordination on EC and IEPG activities affecting defense trade and cooperation, but their recommendations have not been implemented. According to several U.S. government officials, the United States is fortunate that implementation of EC and IEPG initiatives has been slow because the U.S. government is poorly organized to monitor, assess, coordinate, and formulate U.S. positions on these matters. Although an informal, ad hoc DOD group worked with State to counter the EC defense tariff proposal, the group has not met since June 1989. Numerous other concerns and issues raised in chapters 1 through 5 of this report remain unaddressed.

The U.S. Government Is Not Adequately Organized or Tasked to Monitor Defense Trade Implications of EC and IEPG Initiatives

The EC Internal Market Task Force, created in 1988 and chaired by the U.S. Trade Representative, coordinates overall executive branch actions on the civilian impact of EC 92. The task force includes members from 24 different departments and agencies involved in international trade issues, including State and Defense, and is divided into 12 working groups. The task force's mandate is to monitor developments, work with industry, provide information, and establish coordinated U.S. policy on EC 92 matters affecting U.S. commercial interests. We did not review the effectiveness or activities of the interagency task force.

The task force does not have a working group on defense or defense trade issues and does not monitor IEPG activities. However, various working groups monitor certain EC initiatives in the civilian sector, such as standards, rules of origin, and mergers and acquisitions, that may affect defense trade. Commerce chairs and DOD is represented on the working group on standards. In addition, Commerce has established its Single Internal Market Information Service to provide information and assistance to the U.S. business community in preparing for EC 92. Commerce's Trade Development Bureau and the U.S. and Foreign Commercial Service also have EC 92 activities. U.S. embassies and consulates in Europe and the U.S. mission to the EC have also increased their reporting on the commercial aspects of the EC 92 program.

According to several U.S. government officials, the United States has been fortunate that the pace of change within the EC and IEPG has been gradual, because the U.S. government is poorly organized to respond to their initiatives. Over 25 agencies and offices in the Departments of State and Defense have interests in and concerns about the EC 92 process and IEPG activities and their implications for defense trade and cooperation. However, no single office has been formally designated to serve as a coordinating focal point.

A number of State and DOD officials believe that responsible elements in the U.S. government need to better organize to monitor EC and IEPG activities, formulate coordinated U.S. positions in advance, and engage the institutions and member countries at the appropriate levels as necessary.

In March 1989, the Department of State's Bureau of European and Canadian Affairs raised concerns about (1) the effects of EC and IEPG initiatives on trans-Atlantic defense trade and cooperation, (2) the number of Europe-only defense projects, and (3) the allies' performance on their reciprocal defense procurement agreements. State noted that defense trade issues had not always been thoroughly coordinated using political, security, and economic expertise. The Bureau further noted that an interagency group could sensitize agencies to the different outlooks on what have traditionally been discrete disciplines. Based on these concerns, State proposed to the National Security Council that an interagency subgroup be formed under the Europe Policy Coordinating Committee with participants from the State, Defense, and Commerce Departments; the U.S. Trade Representative; the Treasury; and the National Security Council. The National Security Council considered State's concerns; however, this proposal was never acted on. Details of the deliberations are classified.

Also, two DOD offices made recommendations to better monitor and coordinate U.S. policy on these matters but they were not acted on. Details on the recommendations are classified.

Monitoring of European Initiatives Is Diffused

At the Department of State, we interviewed officials from various offices located in the Bureaus of Politico-Military Affairs and European and Canadian Affairs. At each of these offices we obtained information on particular segments of the EC 92 process. For example, the Office of Defense Relations and Security Assistance provided information on defense industrial developments, the Office of Regional Political-

Economic Affairs provided information on certain EC initiatives, and the Office of European Security and Political Affairs provided information on the IEPG and the impact of European integration on NATO. Several officials noted that the State Department's organization does not reflect the cross-disciplinary approach needed to resolve current European integration issues effectively and determine the implications for U.S. defense trade and cooperation.

At DOD, interest and concern over EC and IEPG issues are spread among numerous offices within the Under Secretary of Defense for Acquisition and the Under Secretary of Defense for Policy, the Office of General Counsel, the Defense Intelligence Agency, and the services. For example, concerns have been raised by officials from International Security Policy, International Security Programs, the Defense Security Assistance Agency, and General Counsel (International). Coverage of particular aspects of European defense trade and cooperation issues is spread throughout different offices within the Undersecretaries of Defense for Acquisition and Policy. However, there is no official guidance or tasking for dealing with European integration issues and their implications for defense trade. In addition, officials we met with pointed to the lack of a coordinated DOD approach to assessing the implications of EC and IEPG activities for defense trade and technology transfer policy.

In late 1988, in reaction to the European Commission's defense tariff proposal, DOD formed an ad hoc working group composed of mid-level officials within DOD with State Department participation. Although the group did not have formal standing within DOD, it effectively organized and conveyed U.S. government opposition to the defense tariff proposal to the European Commission and the individual member states.

According to DOD officials and meeting agendas, this ad hoc working group was too narrowly focused on the tariff issue, did not include participants from all the offices that would be affected by the full range of European initiatives, and lacked clout within the bureaucracy. In addition, the group focused on the proposed defense tariff list and did not consider the overall effect that the existing defense tariff regime has had on U.S. bidders' competitiveness since internal tariffs were eliminated within the EC. The working group has not met since June 1989.

Although it is not in the scope of his job description—which is focused on Eastern Europe and the Soviet Union—the Principal Deputy Under Secretary for Strategy and Resources (Policy) told us that he is responsible for coordinating DOD offices' concerns on EC and IEPG matters. He

has delegated this responsibility to the office that held ad hoc meetings on the EC defense tariff issue—International Economic and Energy Affairs—whose current charter specifically excludes Western Europe. The Director of that office told us that he speaks informally on a daily basis with other DOD officials associated with EC and IEPG matters and that formal coordination or task force meetings are not necessary. Nevertheless, International Economic and Energy Affairs has not coordinated with a number of key offices on the full range of issues or on an ongoing basis.

Roles of Other U.S. Agencies

As mentioned, the U.S. Trade Representative chairs the EC Internal Market Task Force. According to an agency official, the task force does not include defense trade or cooperation issues in its scope. The U.S. Trade Representative does participate in briefings by the U.S. Defense Policy Advisory Committee on Trade, which provides industry advice on a broad range of trade and competitiveness issues.

The Commerce Department monitors EC 92 activities related to the civilian market. In addition to activities described above, Commerce chairs the interagency working group on standards. A Commerce official stated that the Department is interested in increased involvement in defense trade issues, but at the time of our review the Department had not tasked anyone to take action or coordinate positions within the administration.

U.S. Missions in Europe Monitoring EC and IEPG Initiatives

The U.S. missions to NATO and the EC, located in Brussels, bear primary responsibility for monitoring IEPG and EC events, respectively. U.S. embassies in Europe also report on member states' reactions to EC and IEPG initiatives and serve as conduits for communicating U.S. government concerns bilaterally.

According to U.S. NATO officials, the U.S. government uses the NATO forum and meetings with the conference of NATO armament directors and their representatives to obtain information on IEPG activities and to convey U.S. positions. In addition, the U.S. mission to NATO uses NATO council meetings (with the Ambassador) and NATO ministerial meetings (with the Secretary of State) to discuss European security and defense trade initiatives.

In 1988, the U.S. Ambassador to NATO tasked the mission's Armaments Cooperation Division and the Office of Economic Advisor to monitor EC

events that would affect defense and security issues. In addition, the mission is responsible for monitoring cooperative development programs in NATO and the continued access of the U.S. defense industry to NATO's European members after 1992.

The U.S. mission to the EC is responsible for coordinating U.S. policy with the EC and monitoring steps toward the single European market. The mission is organized in various sections, including political, economic and commercial, agricultural, and public affairs. According to the mission's charter and U.S. officials, the mission is not tasked to look into or report on the defense implications of EC activities. A former mission official previously monitored and reported on Commission initiatives that would affect defense concerns. However, according to a mission official, defense is a low priority for the mission, and apart from the EC tariff proposal, no developments merit oversight. However, we identified several EC initiatives that could affect U.S. defense trade interests and warrant attention. (See ch. 2.)

One DOD analysis noted that the agency had no representation at the U.S. mission to the EC and is dependent on the State Department to monitor its areas of concern. The analysis also noted that the State Department is preoccupied with issues such as trade in services and nondefense goods. Based on our review of mission files and discussions with mission and other U.S. officials, the U.S. mission to the EC lacked insight into or interest in determining the potential effects of EC initiatives on defense trade and security matters.

U.S. Embassies Are Well Placed to Provide Information

U.S. embassies are the repositories of a large amount of information on host countries' defense trade, contracting, and cooperative program practices. DOD's offices of defense cooperation are the focal points within the U.S. embassies in Europe for managing cooperative weapon systems research, development, acquisition, and support issues. The embassies' economic and political-military sections provide input on host country economic and political considerations that can affect defense trade and cooperation issues. The U.S. embassy in Bonn set a good example in coordinating systematic working sessions with its economic, political-military, and armaments personnel to discuss defense trade and cooperation issues.

One objective of the current armaments cooperation charter that guides U.S. embassy offices on defense cooperation is to identify host country involvement in armaments cooperation with other countries, excluding

the United States, and in projects conducted through multinational organizations such as the IEPG. However, no mention is made of the monitoring of host country contract awards and procurement practices.

U.S. government and defense industry representatives provided numerous examples of perceived preferential or discriminatory defense contract awards, as discussed in chapter 5. Though such perceptions would be difficult to validate, DOD and the State Department have not tasked the embassies to systematically analyze host country procurement decisions or identified a focal point to receive and analyze reports of discriminatory practices. Systematic reporting of host country procurement decisions and discriminatory practices would permit a more accurate assessment of trends in the European defense market and procurement and, if necessary, spur an appropriate U.S. government response.

According to a State Department official, while the U.S. embassies are an important source of information on defense trade and cooperative issues, Washington is not making adequate use of them. The official said that the Washington bureaucracy is not effectively organized to assimilate European defense trade reporting. In our review of office files in Washington, we noted that certain offices did not receive information germane to their areas of responsibility.

Conclusions

The relevant offices within the Departments of State and Defense have not been tasked or organized to effectively monitor, assess, and coordinate and formulate U.S. positions on a number of EC and IEPG initiatives that could have important implications for U.S. defense trade, cooperation, and technology security.

Systematic monitoring and coordination both within and between State and Defense and other agencies on the range of issues and concerns discussed in this report would ensure that U.S. interests are fully protected and that U.S. positions on these matters are formulated and conveyed to the appropriate institutions and countries.

A high-level central forum would bring the various agencies' expertise and concerns to bear in formulating coordinated U.S. policy and positions on these matters. In addition, improved monitoring and internal coordination within the Departments of State and Defense on EC and IEPG matters affecting defense trade would help to support the efforts of a high-level central forum. For example, expertise from key DOD offices

having a stake in defense trade and technology security—such as International Security Policy, International Security Programs, the Defense Security Assistance Agency, and General Counsel (International)—would improve a formal, coordinated DOD effort. Ad hoc and informal coordination has been narrow in scope, incomplete, and short-lived and has resulted in a fragmented approach to the issues.

Recommendations

To improve interagency coordination and policy formulation, we recommend that the Secretary of State form a sub-group under a relevant Policy Coordinating Committee. This group should provide the needed coordination between the Departments of State and Defense, as well as the Treasury, Commerce, and the U.S. Trade Representative, to address EC and IEPG initiatives affecting U.S. defense trade interests.

To improve internal monitoring and assessments in support of the Policy Coordinating Committee, we recommend that the Secretary of State

- direct the Bureaus of Politico-Military Affairs and European and Canadian Affairs to formally coordinate on European initiatives affecting defense trade and cooperation and
- direct the U.S. mission to the EC to monitor, initially assess, and report to the Department on European Commission rules and regulations with possible defense implications.

We recommend that the Secretary of Defense take the following actions:

- Establish a formal defense trade and cooperation working group under the Deputy Secretary of Defense to more fully examine, coordinate, and formulate U.S. positions on European initiatives affecting defense trade, cooperation, and technology security. The working group should include representatives from all DOD offices within Policy, Acquisition, and General Counsel (International) that have a stake and interest in European integration issues.
- Revise the armaments cooperation charter to task U.S. embassies' offices of defense cooperation in the appropriate European nations to (1) track military procurement and evaluate the effect of IEPG initiatives on host government defense procurement practices; (2) determine whether price, capability, or buy-national (or European) criteria were critical factors in awarding contracts; (3) discuss contested contracts with U.S. industry representatives; and (4) determine if trans-Atlantic defense trade is subject to discriminatory practices or invisible barriers.

Objectives, Scope, and Methodology

At the request of the Chairman, Subcommittee on Investigations, House Committee on Armed Services, we examined European initiatives toward forming a single integrated market. Specifically, we

- reviewed activities and initiatives of two European organizations—the EC and the IEPG—and their effect on U.S. defense trade and cooperation;
- identified defense trade activity under reciprocal procurement agreements during the 1980s with the European allies of the North Atlantic Treaty Organization (NATO); and
- examined the roles and organizations of numerous offices in the Departments of State, Defense (DOD), and Commerce and in the Office of the U.S. Trade Representative to determine how U.S.-European defense trade and cooperation issues were being monitored, assessed, and managed.

To determine EC and IEPG plans and activities affecting U.S. defense trade and cooperation, we examined their documents and publications and their progress in meeting goals they had established. We performed work in Europe at the U.S. mission to NATO, the U.S. mission to the EC, and at the U.S. embassies in Belgium, the United Kingdom, and the Federal Republic of Germany, where we interviewed U.S. officials responsible for monitoring the European integration process and defense trade, cooperation, and security issues.

We selected Belgium for our fieldwork because of our focus on European Commission activities and the IEPG member governments' relationship to NATO. We selected Germany and the United Kingdom because they are the largest purchasers of U.S. defense equipment in Europe. We met with ministry of defense and other government officials in Belgium, the United Kingdom, and Germany and spoke with the national armament directors' representatives from eight European countries. We also obtained information from both U.S. and European defense industry representatives. Specifically, we obtained information from representatives of 19 U.S. defense firms. Among those were 8 of the top 10 U.S. defense contractors, based on fiscal year 1988 prime contract awards.

In Washington, we reviewed documents and interviewed officials at the Departments of Defense, State, and Commerce and the U.S. Trade Representative. We conducted research at the EC offices in Washington, where we also met with Commission officials. We met with representatives from think tanks, trade associations, and the U.S. defense industry to obtain their views on EC 92 and its potential impact on U.S. defense

trade. We attended symposiums on defense trade and European integration. Finally, we obtained and analyzed numerous reports, briefings, and articles on EC 92 and defense trade and cooperation.

In examining activities occurring under reciprocal defense procurement MOUs, we first reviewed the relevant agreement provisions and determined their relationship to U.S. and European practices. We focused on the reciprocal obligations to waive customs duties and buy-national restrictions and to evaluate bids without considering tariffs imposed.

We examined data compiled by DOD on the bilateral defense procurement balance between the United States and each of the 13 countries that are members of the IEPG for fiscal years 1983-87. We assessed the data DOD published on an annual basis and the data DOD updated in January 1990 for those fiscal years. We also examined IEPG countries' practices on applying defense tariffs and evaluating bids from U.S. firms in light of the tariffs, reviewed relevant U.S. government documents, and interviewed European defense officials.

We reviewed the data DOD uses to measure the defense procurement balance and examined its methodology in calculating the balances. In addition to the DOD approach discussed in chapter 4, varying European defense procurement and budgeting practices complicate assessments of the defense trade or procurement balances on an annual basis. For example, the United Kingdom sometimes spreads its actual expenditures for FMS purchases over time, while Italy "puts the money up front."

DOD's data on U.S. procurement of European defense items has limitations. This data is compiled from standard reporting forms, which include foreign prime contracts over \$25,000 and first and second tier foreign subcontracts exceeding \$25,000 under certain conditions.¹ Prime contractors report their first tier foreign subcontracts over \$25,000 only if the value of the prime contract is over \$500,000. Additionally, first tier domestic subcontractors report their second tier foreign subcontracts over \$25,000 only if the first tier subcontract exceeds \$100,000.

Also, DOD's data is not validated, and DOD does not know whether U.S. contractors are complying with the reporting requirement on their subcontracts abroad. If a contractor does not file a report, it is not known

¹DOD estimates that its foreign procurement of items using direct purchase contracts of \$25,000 or less amounted to \$1,028,571,000 in fiscal year 1988. This amount includes construction, fuels, and lubricants, which are excluded from the DOD procurement balance data base.

whether it failed to file or whether it had no foreign subcontracts over \$25,000. DOD officials stated that they do not follow up on these forms because it would be very difficult to do so. DOD recognizes these shortcomings in its data base.

Our alternative assessment of the defense trade balances focused on defense equipment delivery data from the Departments of State and Defense. We substituted FMS delivery values provided by the Defense Security Assistance Agency for the FMS agreement values used by the Office of Foreign Contracting, while retaining the same Department of State figures to calculate U.S. commercial defense exports. For U.S. defense purchases from the IEPG countries, we used DOD's data.

In our view, a relatively valid assessment of MOU defense trade activity could be made using FMS and commercial military equipment delivery data for three reasons. First, the use of delivery data on FMS items is consistent with State's use of delivery data on commercial items. The Office of Foreign Contracting agreed that the delivery data is more accurate in the long run. Second, our data does not reflect negotiated ratios. Third, FMS and commercial military sales delivery data excludes exports of nondefense items. However, DOD's data on its purchases from the IEPG countries does include dual use items.

We recognize the limitations of our methodology. In using delivery data to measure FMS activity, we recognize that the time lag between contract award and actual delivery can be a number of years (usually less than 3 but as much as 5 for aircraft and even longer for ships). Because of this lag, it is difficult to make a meaningful comparison of the year-to-year procurement and trade activity between the United States and individual European nations. Limitations on the State Department's commercial munitions export data affect both our and DOD's analyses. State's delivery data for items shipped under export licenses has three important limitations: (1) the value of items shipped might be counted twice under certain conditions, making an accurate accounting of the cumulative value of actual shipments under a given license difficult; (2) the value of items shipped under these licenses may not be reported for a number of years, and the data entered even for older licenses could change; and (3) dual-use items exported under licenses issued by the Department of Commerce are not included, even if specifically purchased by a foreign government using defense procurement funds.

We also measured the activity in defense trade by comparing changes in the levels of the combined defense procurement budgets of the IEPG

countries to changes in the total level of their defense procurement devoted to imports of defense items from the United States for fiscal years 1983-87. We compared information on IEPG members' reported defense procurement spending levels to U.S. defense export delivery data. However, we did not verify the budget data provided by the European governments. Finally, we examined the changing composition of U.S.-IEPG defense trade by calculating changes in the ratio of FMS to commercial sales on the export side of the balance.

In examining the indications of European preference in defense procurement and codevelopment projects, we reviewed numerous U.S. government reports, assessments, and analyses. We further discussed a number of individual contract awards with U.S. government and defense industry representatives and with British and German defense ministry officials. We did not review documentation on the bids or contract awards, nor did we do a statistically valid sample.

To determine how the administration is organized and prepared for EC 92 and military sales and cooperation, we reviewed taskings, charters, and directives for the pertinent offices within the Departments of Defense, State, and Commerce and the U.S. Trade Representative. We met with DOD officials in the offices of Production and Logistics, Industrial and International Programs, International Security Policy, Strategy and Resources, Security Policy, General Counsel, Defense Security Assistance Agency, and the military services to discuss European initiatives and assess how the U.S. positions on these initiatives were being coordinated, formulated, and conveyed. At the Department of State we met with officials from the Bureau for Politico-Military Affairs and the Bureau for European and Canadian Affairs. At the Department of Commerce we met with officials from the Bureau of Export Administration and the International Trade Administration. At the U.S. Trade Representative we met with officials from the office of Europe and Mediterranean Affairs and the Special Advisor for Defense Trade Policy.

Overall limitations on our work and observations stem from the fluid political events in Europe and the scope and focus of our review. For example, we approached a number of European defense officials about the potential effects that the reunification of East and West Germany and the democratization of Eastern Europe might have on the IEPG's plans and activities. While some were uncertain about the effects, others noted that IEPG initiatives would not be thwarted but that programs might be scaled down and the number of programs might be reduced.

Second, while we examined indications of perceived European preference in defense contract awards and codevelopment programs, numerous U.S. and European officials noted that the United States also expresses preference and possibly discriminates in favor of U.S. contractors. While these views may have merit, our scope was limited by necessity to indications of European preference.

We performed our review from August 1989 through November 1990 in accordance with generally accepted government auditing standards. As requested, we did not obtain written agency comments. However we discussed our findings and recommendations with responsible officials from the Departments of Defense and State and the Delegation of the Commission of European Communities in Washington and have included their comments as appropriate.

Excerpts of the Treaty of Rome and the Single European Act

"TREATY OF ROME ESTABLISHING THE EUROPEAN COMMUNITY

"Article 223

- "1. The provisions of this Treaty shall not preclude the application of the following rules:
 - a) No Member State shall be obliged to supply information the disclosure of which it considers contrary to the essential interests of its security;
 - b) Any Member State may take such measures as it considers necessary for the protection of the essential interest of its security which are connected with the production of or trade in arms, munitions and war material; such measures shall not adversely affect the conditions of competition in the common market regarding products which are not intended for specifically military purposes.
- "2. During the first year after the entry into force of this Treaty, the Council shall, acting unanimously, draw up a list of products to which the provisions of paragraph 1b) shall apply.
- "3. The Council may, acting unanimously on a proposal from the Commission, make changes in this list."

"SINGLE EUROPEAN ACT

"ARTICLE 30

"6a) The High Contracting Parties consider that closer cooperation on questions of European security would contribute in an essential way to the development of a European identity in external policy matters. They are ready to coordinate their positions more closely on the political and economic aspects of security.

"b) The High Contracting Parties are determined to maintain the technological and industrial conditions necessary for their security. They shall work to that end both at national level and, where appropriate, within the framework of the competent institutions and bodies.

"c) Nothing in this Title shall impede closer cooperation in the field of security between certain of the High Contracting Parties within the framework of the Western European Union or the Atlantic Alliance."

Products Referred to in Article 223, the Treaty of Rome

The provisions of article 223, paragraph 1b, of the Treaty of Rome are applicable to the arms, munitions, and war material specified below, including nuclear arms:

1. Portable and automatic firearms, such as rifles, carbines, revolvers, pistols, submachine guns and machine guns, except for hunting weapons, pistols, and other low caliber weapons of the caliber less than 7mm
2. Artillery and smoke, gas, and flame-throwing weapons such as
 - a. cannons, howitzers, mortars, artillery, anti-tank guns, rocket launchers, flamethrowers, recoilless guns
 - b. military smoke and gas guns
3. Ammunition for the weapons at 1 and 2 above
4. Bombs, torpedoes, rockets, and guided missiles:
 - a. bombs, torpedoes, grenades, including smoke grenades, smoke bombs, rockets, mines, guided missiles, underwater grenades, incendiary bombs
 - b. military apparatus and components specially designed for the handling, assembly, dismantling, firing or detection of the articles at 4a. above
5. Military fire control equipment:
 - a. firing computers and guidance systems in infrared and other night guidance devices
 - b. telemeters, position indicators, altimeters
 - c. electronic tracking components, gyroscopic, optical and acoustic
 - d. bomb sights and gun sights, periscopes for the equipment specified in this list
6. Tanks and specialist fighting vehicles:
 - a. tanks
 - b. military-type vehicles, armed or armored, including amphibious vehicles
 - c. armored cars
 - d. half-tracked military vehicles
 - e. military vehicles with tank bodies

- f. trailers specially designed for the transportation of the ammunition specified at paragraphs 3 and 4
- 7. Toxic or radioactive agents:
 - a. toxic, biological, or chemical agents and radioactive agents adapted for destructive use in war against persons, animals, or crops
 - b. military apparatus for the propagation, detection, and identification of substances at paragraph 7a. above
 - c. countermeasures material related to paragraph 7a. above
- 8. Powders, explosives, and liquid or solid propellants:
 - a. powders and liquid or solid propellants specially designed and constructed for use with the material at paragraphs 3, 4, and 7 above
 - b. military explosives
 - c. incendiary and freezing agents for military use
- 9. Warships and their specialist equipment:
 - a. warships of all kinds
 - b. equipment specially designed for laying, detecting, and sweeping mines
 - c. underwater cables
- 10. Aircraft and equipment for military use
- 11. Military electronic equipment
- 12. Camera equipment specially designed for military use
- 13. Other equipment and material
 - a. parachutes and parachute fabric
 - b. water purification plant specially designed for military use
 - c. military command relay electrical equipment
- 14. Specialized parts and items of material included in this list insofar as they are of a military nature
- 15. Machines, equipment, and items exclusively designed for the study, manufacture, testing, and control of arms, munitions, and apparatus of an exclusively military nature included in this list

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