Foreign Military Financing Program Funds

GAO

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The Honorable Cardiss Collins
Chairwoman, Subcommittee on Commerce,
Consumer Protection, and Competitiveness
Committee on Energy and Commerce
House of Representatives

The Honorable Russell D. Feingold
United States Senate

As you requested, we have reviewed offset arrangements associated with foreign military sales financed through the U.S. Foreign Military Financing (FMF) Program. For the purposes of our review, offsets are defined as an entire range of industrial and commercial compensation practices provided to foreign governments and firms as inducements or conditions for the purchase of military goods and services. Israel, Egypt, Greece, and Turkey are the largest recipients of the FMF program. Since fiscal year 1975, the United States has provided over $60.1 billion[1] in FMF funding consisting of grants and loans to these countries.[2]

Our objectives were to (1) determine the nature and extent of offsets required by the four largest recipients of FMF funding when purchasing U.S. military goods and services; (2) determine whether and how U.S. government funds paid for the offsets and their costs; (3) analyze applicable laws, policies, and regulations with respect to offsets; and (4) make observations on the impacts of offsets on U.S. business, trade, and industrial competitiveness. We did not review offsets associated with purchases made by foreign governments using their own national funds.

Background

Foreign governments often require or request offsets to reduce the financial impact of their purchases; obtain valuable technology and manufacturing know-how; support domestic employment; create or expand their defense industries; and make using their national funds for offshore purchases more politically palatable. Offsets are considered an important competitive tool for U.S. contractors, particularly when selling

[1]All dollar amounts stated in this report are expressed in then-year dollars.

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

to countries making purchases with their national funds and when foreign competition is involved.

Applicable laws provide that FMF funding is generally intended to finance purchases of U.S. military goods and related services. According to the Department of Defense (DOD), FMF funding enables foreign countries to improve their defense capabilities by financing acquisitions of U.S. military articles, services, and training. As FMF funding helps countries provide for their defense needs, it promotes U.S. national security interests by strengthening coalitions with friends and allies and cementing military-to-military relationships.

In addition to supporting foreign policy and national security objectives, the Departments of State and Defense justify the FMF program in part on the U.S. employment, industrial base, and other benefits it generates. The Foreign Assistance Act authorizes security assistance programs and provides conditions on eligibility and financing. DOD's Defense Security Assistance Agency (DSAA) administers the FMF program that finances foreign countries' acquisitions of U.S. military goods and services. These acquisitions are made through both government-to-government and direct commercial (foreign government with U.S. contractor) channels.

The President's April 1990 policy on offsets provides that U.S. government funds shall not be used to finance offsets in security assistance sales except in accordance with currently established policies and procedures. It does not, however, spell out what "currently established policies and procedures" are. The policy also (1) recognizes the need to minimize the market distortive and other adverse effects of offsets, (2) reaffirms the traditional U.S. government policy of noninvolvement in offset arrangements, and (3) emphasizes that U.S. firms are responsible for negotiating offset arrangements with foreign governments. This policy was later incorporated into the Defense Production Act (P.L. 102-558, approved Oct. 28, 1992).

We reviewed offsets associated with 48 contracts valued at $11.6 billion to sell weapon systems and other items through government-to-government and direct commercial channels by 3 major U.S. defense contractors.[3] The contracts were financed wholly or partially with FMF grants, loans, or both. Although our review identified a wide variety of offsets, the full extent of offsets arising out of all FMF financed purchases is not known.

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

Furthermore, it is difficult to assess the impacts of these offsets on overall U.S. employment.

Results in Brief

Current U.S. laws, policy, and regulations do not prohibit offsets when recipients are making purchases with FMF funding. As a result, Israel, Egypt, Greece, and Turkey have been allowed to use FMF grants and loans to obtain billions of dollars in offset obligations. In the cases we reviewed, FMF recipients who obtained offsets benefited in two ways—first with the U.S. government funding the purchase, and then by obtaining offsets from the U.S. government and contractors. The largest dollar offset obligations included agreements to allow the FMF recipient to produce parts of the weapon system it purchased, agreements for the U.S. contractor to buy parts from the recipient, and agreements by the U.S. contractors to link buyers and sellers of commodities exported by the FMF recipient.

While FMF grants and loans support U.S. foreign policy and security objectives, certain types of offsets reduce the employment, defense industrial base, and other economic benefits that normally accrue to the United States from foreign military sales. For example, some offsets require U.S. contractors to place subcontract business offshore with recipient countries' industries that might have otherwise been performed in the United States. These offsets have resulted in a loss of some production work for U.S. prime contractors and subcontractors. Our review indicates that offsets can also result in displacement of U.S. subcontractors and create new competitors for U.S. companies in the world market. Thus, to some extent, the recipients' goals in seeking offsets conflict with U.S. goals.

According to knowledgeable DOD officials, the FMF grant aid program is unique in the world. No other arms supplier has a program that provides a combination of grant aid and allows offsets. Since applicable legislation provides that FMF grants are generally intended to fund purchases of U.S. military goods and related services, it is unlikely U.S. contractors would lose sales to foreign competitors if they could not provide offsets in sales funded with U.S. grant aid. Instead, U.S. companies compete against each other for FMF grant-funded purchases.

Applicable legislation does not prohibit offsets associated with purchases made with U.S. FMF funds. The President's 1990 offset policy, adopted by Congress, contains an exception that is not defined and actually allows U.S. government funds to pay for offsets in security assistance transactions. As a result, FMF grants and loans or U.S. military procurement funds pay for some offsets and their associated costs.

Nature and Extent of Offsets With Israel, Egypt, Greece, and Turkey

To varying degrees, Israel, Egypt, Greece, and Turkey are using the FMF program to obtain offsets. Accordingly, they benefit in two ways—first, with the U.S. government financing the purchase and then, by developing their industrial bases through offset requirements.

Since fiscal year 1987, Israel and Egypt have received FMF grants valued at $1.8 billion and $1.3 billion each year, respectively. Additionally, since fiscal year 1991, Israel has been specifically authorized to spend $475 million of the $1.8 billion it has received for procurements from within Israel. Before fiscal year 1993, Turkey and Greece had received both FMF grants and loans. Some of the FMF loans were made at concessional rates. In fiscal year 1993, Turkey received FMF loans valued at $450 million, and Greece received $315 million in loans.

Offset obligations are commitments made by the U.S. government and U.S. contractors to the foreign governments that are purchasing U.S. military goods and services. Offset obligations can arise out of government-to-government agreements and agreements or understandings between the U.S. contractors and foreign governments. Offsets are either direct—related to the weapon system being bought—or indirect—related to other products and services. Table 1 shows $4.7 billion in offset obligations generated from the $11.6 billion in contracts we reviewed. The table also illustrates the wide variety of direct and indirect offsets identified. (See app. I for a detailed discussion of these offset obligations.)

Table 1: Types of Offsets and Associated Offset Obligations

Dollars in millions

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

[a]Many of the cases we reviewed involved more than one type of offset. Therefore, the number of cases displayed in this table exceeds our sample quantity of 48.

[b]The contractor could not quantify the value of parts and components purchased from one country. As a result, this figure does not include that amount.

[c]The value of these offset obligations were not quantified because they were based on subjective judgments or not known in all situations.

[d]Through subsequent negotiations between the U.S. contractors and FMF recipients, these offset obligations were later satisfied with U.S. contractor investments in non-defense firms costing $37.8 million.

[e]Offset obligations amounting to $28 million could be satisfied either through the trading of commodities or foreign defense-related projects.

U.S. Funds Pay for Some Overseas Production and Some Costs Associated With Offsets

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

government, above what it would have paid in the absence of the offsets, depends on the type of offset and on whether products produced under offset arrangements are purchased from foreign suppliers at prices comparable to those offered by U.S. domestic suppliers. U.S. contractors stated that buybacks and other procurements were made at competitive or reasonably competitive prices and did not result in extra costs to the government. Nevertheless, buybacks and other procurements result in additional foreign content in U.S. weapons. Table 2 shows that U.S. government funds pay for some offsets and associated costs resulting from military sales to FMF recipients.

Table 2: U.S. Government Funds Pay for Some Offsets and Costs While U.S. Contractors Pay for Others

Financial treatment of offsets	Type of offset	U.S. funds pay for some offsets and costs
Offsets included in military sales contract paid with FMF grants	Coproduction	Yes
	Directed subcontracting	Yes
	Technology transfers	Yes
	Some offset administration costs	[a]
Offsets passed through to other customers, including the U.S. government	Buybacks (related)	Yes[b]
	Procurements (unrelated)	Yes[b]
	Trading of commodities	No
Costs charged to overhead and allocated to other contracts, including U.S. government contracts	Marketing and negotiating offset arrangements	Yes
	Some offset administration costs	Yes
Reductions to contract profit, corporate earnings, or cash made by the U.S. contractors	Investments (defense firms)	No
	Investments (non-defense firms)	No
	Concessions	No
	Some offset administration costs	No

[a]Because direct commercial contracts are not cost-based or subject to federal or defense acquisition regulations, it is not possible to determine what costs are included in these types of contracts.

[b]U.S. contractors stated that buybacks and procurements did not result in increased costs to the U.S. government.

Of the various types of offsets presented in table 2, specific examples pertaining to FMF recipient countries are discussed below.

- Of the coproduction obligations valued at about $1.2 billion, the cases we reviewed included FMF grant-funded coproduction and directed subcontracting valued at about $387.9 million. For example, Israeli companies were paid to produce parts that were incorporated into weapon systems that the United States provided to Israel free of charge.[4]

- The U.S. military services and other customers purchased weapon systems that contained about $1.2 billion in components acquired through buybacks or other procurements from Israel by the U.S. contractors. Neither we nor the contractors could quantify or distinguish the total values being purchased with U.S. government funds. U.S. contractors stated that buybacks and other procurements were made at competitive or reasonably competitive prices and therefore did not result in extra costs or premiums to the U.S. military services. Nevertheless, the offsets result in the U.S. military services buying additional foreign content in their weapon systems.
- In one situation, Turkey used a combination of $3.2 billion in FMF grants and loans and $1 billion of its own national funds to purchase a U.S. weapon system. The government of Turkey requested and the U.S. government allowed Turkish companies to assemble and produce parts of the weapon system valued at $363.5 million, with follow-on coproduction valued at $396.5 million. Turkish funds paid for these industrial participation activities, but FMF grants and loans enabled Turkey to finance the rest of the purchase and to require these offsets.
- The government of Egypt, using FMF grants, purchased the same U.S. weapon system being acquired by Turkey. At the U.S. government's initiative and request, Egypt allowed Turkey to assemble the weapon system for delivery to Egypt, instead of having the weapon system assembled and delivered from the United States. Further, an Egyptian company, paid with Turkish national funds, will produce selected parts of the Turkish-assembled, U.S. origin weapon system. As a result, production work—largely assembly and some fabrication—that would have been performed in the United States was moved offshore.

In some situations, certain offset administrative costs incurred by U.S. contractors were charged to overhead pools and allocated to other domestic contracts. Charging offset administration costs to overhead pools is contrary to Defense Contract Audit Agency guidance, which interprets the regulations. Although the agency's interpretation is not specifically reflected in federal and defense acquisition regulations, the agency's guidance states that these costs are allocable to the benefiting foreign military sales contracts and should not be charged to indirect

[4]In another example of coproduction, outside the 48 cases we reviewed, FMF grants funded the M1A1 tank coproduction program in Egypt, which led to significantly increased costs. See Military Aid to Egypt: Tank Coproduction Raised Costs and May Not Meet Many Program Goals (GAO/NSIAD-93-203, July 27, 1993).

expense pools and allocated to domestic business, including domestic government contracts. Two U.S. contractors informed us that they allocated the in-house costs for implementing their offset agreements to other contracts, including those with the U.S. military. However, one of these two U.S. contractors stated that these costs were minimal and allocated to overhead accounts consistent with its disclosure statement regarding the recovery of such costs.

U.S. Contractors Pay for Offsets

The actual costs of offsets to the U.S. contractors are substantially lower than the total amount of the offset obligations. Costs associated with concessions and administrative offset costs such as commodity trading and independent contractor expenses that are not priced into the contracts are being taken out of contract profit or company earnings. In addition, investments in foreign defense-related and non-defense firms reduce corporate cash or contract profit and may eventually reduce corporate earnings if the investments result in losses. On the other hand, purchase prices of foreign-produced parts and components both related and unrelated to the U.S. military system being acquired are ultimately paid for by other customers, including the U.S. military services, domestic companies, or foreign customers. Further, the prices of commodities brokered or traded are paid for by the purchasers of the commodities.

Federal Laws and Regulations Do Not Prohibit Offsets With FMF Grants and Loans

Current U.S. laws, policies, and regulations do not preclude FMF recipients from requiring, requesting, or obtaining offsets when they purchase U.S. military goods and services using FMF funding. FMF grants and loans are generally intended to finance purchases of U.S. military goods and services. The Foreign Assistance Act and Arms Export Control Act provide that FMF grants and loans should not be used for coproduction, licensed production, and procurements outside the United States except under certain limited conditions. Section 42 (b) of the Arms Export Control Act provides that if FMF grants or loans are used for coproduction, or licensed production outside the United States, the Secretary of State must report on the probable impacts of the proposed sales on employment and production in the United States. Section 42 (c) requires the President to make a determination that U.S. economic interests will not be adversely affected before authorizing foreign procurements in connection with an FMF-funded transaction. However, the applicable laws do not prohibit offsets with FMF grants and loans or address their effects such as imports into the United States.

The President's April 1990 offset policy provides that U.S. government funds shall not be used to finance offsets in security assistance sales except in accordance with currently established policies and procedures (emphasis added). This exception, however, is not defined. Under the policies and procedures existing in 1990, offsets including coproduction and designated work were occurring in sales being financed with FMF grants and loans. As a result, the prohibition contained in the policy is largely neutralized. Nevertheless, this policy was incorporated in section 123 of the Defense Production Act.

Federal acquisition regulations address the treatment of some but not all costs related to offsets. For example, costs associated with marketing and negotiating offsets are allowed in U.S. government contracts as selling expenses. In addition, offset administration costs are allowed in foreign military sales contracts under certain conditions. (See app. II for additional information on the President's offset policy and related government acquisition regulations.)

Offsets Are a Questionable Use of U.S. FMF Grants and Loans

While FMF grants and loans support U.S. foreign policy and security objectives, the recipient countries' goals in seeking offsets include promoting economic development, creating jobs, and enhancing self-sufficiency and the potential for arms exports. To some extent, some of these goals conflict with U.S. goals, especially those promoting economic development and creating jobs in the United States.

While offsets are an integral part of the world marketplace, they are not needed to ensure a sale and may not be appropriate when the purchasing country is using FMF funding intended to finance sales of U.S. weapon systems. To the extent that certain types of offsets are provided, the employment and other benefits to the United States of the foreign military sales are reduced. In sales financed with FMF funding, especially FMF grant aid, foreign competition is not a factor because these funds are generally intended to purchase U.S. military goods and related services.

Observations on the Impacts of Offsets

Although the long-term impact of offsets on overall U.S. trade and employment depends on a number of factors, effects of offsets on certain industries and firms can be identified. In the cases we reviewed, FMF recipients were allowed offsets, including coproduction, buybacks and other procurements, directed subcontracting, and technology transfers. Technology transfers help the foreign countries establish defense industrial capabilities by providing valuable technology and manufacturing know-how. Coproduction, buybacks, other procurements, and directed subcontracting support the foreign countries' domestic employment, and create, maintain, or expand their defense industries.

In some cases, once established through offset obligations, foreign producers have become highly competitive with U.S. subcontractors, prompting the U.S. prime contractors to maintain long-term supplier relationships with the foreign customers' industries. These relationships may benefit the U.S. prime contractors. According to an industry spokesman, these supplier relationships may even reduce the prime contractors' prices, but at a cost to the U.S. industrial base.

Offset obligations we examined have provided incentives to U.S. prime contractors and first-tier subcontractors to place business offshore with recipient countries' industries, and resulted in the loss of business and possible displacement of U.S. subcontractors. Because of the lack of data, the full extent to which foreign suppliers have actually displaced U.S. suppliers cannot be accurately measured. However, we obtained anecdotal information on how some specific offsets arising from sales funded wholly or partially with grant aid adversely affected U.S. subcontractors' business.

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

Another subcontractor told us it was required by the prime contractor to grant a licensing agreement to an Israeli company to produce 30 percent of a certain subsystem. The U.S. subcontractor also stated that it felt the adverse effect of the offset was outweighed by the additional sales of this item for the company generated by the sale of the weapon system to Israel. The subcontractor must now compete internationally with the Israeli company to supply a similar subsystem. The subcontractor added that the Israeli company argues that it is not using the U.S. design. However, according to this subcontractor, the subsystem appears very similar to its design and it would be simple to change a few aspects of the design and have it be considered a unique system.

We found cases in which the U.S. prime contractors agreed to offsets that affected their in-house production work. For example, in one case, a prime contractor allowed coproduction and then made buybacks from an Israeli company of a major assembly for U.S. and foreign customers' procurements. This item had initially been produced at one of the prime contractor's facilities, which, for a variety of reasons, is now closed.

In another case, U.S. prime contractors provided Turkey with the capability to produce parts and components that were incorporated both in the weapon system sold to the government of Turkey as well as purchased back for later incorporation into other similar U.S. weapon systems. Although this sale resulted in additional production of this system in the United States, the offsets caused some production work to be moved from the United States to Turkey. For those parts produced by U.S. subcontractors, two subcontractors told us they lost work that could not be replaced. Both subcontractors noted that as a condition of their contracts with the U.S. prime contractor, work had to be given up so that the prime contractor could satisfy its offset obligations.

Competitive Pressures in Grant-Funded Sales

U.S. contractors stated that foreign military sales help maintain production lines in the United States and that they must provide foreign purchasers with coproduction, subcontracting opportunities, and other offsets to ensure the sales are made. However, when FMF grants finance the purchase of the U.S. weapon system, U.S. contractors should not be required or need to provide offsets since foreign suppliers are not competing for the sale.

During 1993, U.S. aircraft and engine contractors were competing against each other for a $2 billion aircraft sale to Israel to be funded with FMF grants. In this case, the U.S. contractors had no foreign competition because of the intended use of FMF grant aid to fund the fighter aircraft purchase. As a result, U.S. contractors were competing only with each other for the sale, an integral part of which was the offset package because offsets were a condition of the sale.

According to a trade association spokesman, in such cases there may be a clear distinction between the interest of the U.S. company—which is to win the sale—and the interests of the U.S. government—which are to maximize the effectiveness of its aid program and the industrial benefits to the United States. He noted that in the absence of a U.S. government prohibition, if a single company tries to unilaterally restrict its offset offers, it may simply lose the sale to the other U.S. company that does provide such offsets.

According to knowledgeable DOD officials, no other arms supplier provides a combination of grants and offsets to compete in the world market. They noted that other arms suppliers generally provide loans and free military equipment. Still, certain U.S. contractor representatives we interviewed did not believe that FMF recipients should be prohibited from requiring offsets on their purchases and expressed concerns about a possible prohibition, particularly with how such a prohibition could be enforced in practice.

Matters for Congressional Consideration

Offsets are not now prohibited and are being required and requested by FMF recipients. Because of the impacts on U.S. business and other factors, the question arises whether the United States should provide FMF funding and also allow offsets. Congress may wish to consider amending the Foreign Assistance Act and the Arms Export Control Act to prohibit the use of FMF grants to pay for or request, require, obtain or provide offsets in connection with sales of U.S. military goods and services. Case-by-case exceptions could be made for specifically justified compelling U.S. national security or foreign policy reasons. Congress may also wish to apply the prohibition to purchases made with FMF loans made at concessional rates. Congress could further make a condition of the FMF grant aid that the recipients agree not to request, require, or obtain offsets. To help with enforceability, the amendment could require contractors to certify that they have not and will not provide offsets in connection with such sales. Congress may also wish to amend section 123(a)(2) of the Defense Production Act by eliminating the exception that allows U.S. government funds to finance offsets in security assistance transactions.

Views of DOD Officials and U.S. Contractors and Our Response

In discussing the contents of a draft of this report, officials of the Office of the Under Secretary of Defense for Acquisition and DSAA stated that DOD was complying with existing legislation and all DOD policies and regulations pertaining to offsets arising out of government-to-government and direct commercial sales to FMF recipient countries. We agree that DOD is complying with existing laws, policies, and regulations because applicable legislation does not prohibit offsets and the exception in the President's April 1990 offset policy allows the use of U.S. government funds to finance offsets in security assistance transactions. Additionally, federal acquisition regulations do not apply to direct commercial sales contracts funded by FMF grants and loans.

DOD officials also stated that a prohibition on the use of FMF grants to pay for or request offsets appeared reasonable. Further, most U.S. contractor representatives we met with acknowledged that they are competing only with each other for grant-funded foreign military sales. However, they were concerned about a prohibition on obtaining offsets using FMF loans, because the recipients repay these loans with their national funds. We agree that FMF recipient countries intend to repay FMF loans with their national funds. However, some loans have been provided at concessional rates or have been forgiven at a later date.

Both the DOD officials and the U.S. contractors we contacted noted it would be extremely difficult to enforce a proposed prohibition on offsets using FMF grant funds. To ensure enforceability, contractors could be required to certify that they have not and will not provide offsets in connection with grant-funded sales. Certain contractor representatives noted that the United States could also include as a condition of grant aid a prohibition on recipients requiring, requesting, or obtaining offsets. We agree and adjusted our matters for congressional consideration section accordingly. (See app. III for a more detailed discussion of DOD and U.S. contractors' comments.)

We conducted our review from June 1993 to March 1994 in accordance with generally accepted government auditing standards.

As requested, we did not obtain written agency comments on this report. We did, however, obtain oral comments from officials of the Office of the Under Secretary of Defense for Acquisition, DSAA, and other DOD agencies, the three U.S. contractors involved, and a trade association spokesman. We have included their comments as appropriate. A discussion of our scope and methodology is in appendix IV.

Unless you announce its contents earlier, we plan no further distribution of this report until 5 days from its issue date. At that time, we will send copies to other interested congressional committees and Members of Congress, and the Secretaries of State and Defense. We will make copies available to others upon request.

If you or your staff have further questions about this report, please call David E. Cooper, Director, Acquisition Policy, Technology, and Competitiveness Issues, on (202) 512-4587. Other major contributors to this report are listed in appendix V.

Frank C. Conahan

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Assistant Comptroller General

Contents

Abbreviations

DFARS	Defense Federal Acquisition Regulation Supplements
DOD	Department of Defense
DSAA	Defense Security Assistance Agency
FAR	Federal Acquisition Regulation
FMF	Foreign Military Financing

Types of Offset Obligations With Israel, Egypt, Greece, and Turkey

Direct Offsets

Direct offset obligations associated with the 48 Foreign Military Financing (FMF) contracts to Israel, Egypt, Greece, and Turkey consisted of coproduction, buybacks, directed subcontracting, investments in defense-related firms, concessions, and technology transfers/licensed production.

- Coproduction is overseas production based on government-to-government or producer agreements that permit a foreign government to acquire the technical information and tooling to manufacture all or part of a U.S. origin defense article. Based on the 48 cases we reviewed, coproduction activities took place to varying degrees in Turkey, Israel, Greece, and Egypt. In one case, for instance, using FMF and national funds, Turkey produced parts and components and assembled the final weapon system. This arrangement led to coproduction valued at about $760 million.
- Buybacks involve the U.S. contractor providing data and sometimes technical assistance and tooling to enable the foreign country to produce defense components directly related to the U.S. military system being acquired and then purchasing these components. In some cases, coproduction has led to buybacks. Buyback arrangements have been made with Israel, Turkey, and Greece. For example, Israel and Turkey were sources of buybacks valued at $631.2 million and $316.9 million, respectively. These buybacks were components incorporated in equipment purchased by the U.S. military services and other foreign customers.[1] The contractors stated that the buybacks were competitively priced with components made by U.S. subcontractors or other suppliers.
- Directed subcontracting involves the procurement of Israeli- or Egyptian-made components for incorporation or installation in the U.S. items sold to Israel or Egypt under direct commercial contracts. From fiscal years 1984 to 1992, Israel was authorized to use FMF funding amounting to $1.2 billion for these types of direct offsets while Egypt was authorized to use a total of $80 million.
- Investments in defense firms take the form of capital invested to establish or expand a company in the foreign country. Specifically, U.S. contractors made investments in Turkish firms that supported the coproduction of parts and components as well as final assembly of the weapon system.
- Concessions are commercial compensation practices whereby capabilities and items are given free of charge to the foreign country. To varying degrees, concessions were provided to Turkey, Israel, Greece, and Egypt.
- Technology transfers/licensed production help the foreign countries establish defense industry capabilities by providing valuable technology

[1] Neither we nor the contractors could quantify the total amounts paid by each of these customers.

and manufacturing know-how. All four countries benefited from technology transfers or licensed production, or both.

Indirect Offsets

The cases we reviewed included a variety of indirect offset obligations.

- Procurements involved purchases of foreign-produced parts/components unrelated to the U.S. military system being acquired. U.S. contractors made most of these purchases from Israel and incorporated them into weapon systems or commercial items purchased by the U.S. military services, other U.S. customers, and foreign customers that may or may not receive U.S. assistance.
- Investments in non-defense firms consisted of establishing corporations in Greece and Turkey to invest capital in companies in those countries. For example, U.S. contractors financed the establishment of a Greek corporation, which in turn, invested in companies engaged in medical diagnostics, sportswear manufacture, computerized numerically controlled wire bending machines, software systems for the financial services industry, and woven and non-woven textiles.
- Trading of commodities involved using brokers to link buyers with the foreign commodities sellers. Offsets of this type were provided to Israel, Turkey, and Greece. The foreign commodities traded included wiring, petroleum, and other chemicals.
- Foreign defense-related projects assisted the recipient country's military services. For example, a U.S. contractor hired an independent contractor to assist the Greek military in enhancing military operations.

The companies employed a variety of methods to implement their offset obligations, including the use of brokers and independent contractors. However, for the four countries covered by our review, U.S. contractors stated that they had not made incentive payments to other U.S. companies to induce them to select foreign competitors over other U.S. companies bidding on domestic business.

Presidential Offset Policy and Acquisition Regulations

President's Offset Policy Statement

The President's policy statement of April 16, 1990, states that the U.S. government is committed to the principles of free and fair trade. However, it recognizes the need to minimize the adverse effects of offsets without undermining U.S. firms' competitiveness. It notes that the U.S. government views certain offsets for military exports as economically inefficient and market-distorting. In addition, the policy statement specifies:

- "No agency of the U.S. Government shall encourage, enter directly into, or commit U.S. firms to any offset arrangement in connection with the sale of defense goods or services to foreign governments."
- "U.S. Government funds shall not be used to finance offsets in security assistance transactions except in accordance with currently established policies and procedures."
- "Nothing in this policy shall prevent agencies of the U.S. Government from fulfilling obligations incurred through international agreements entered into prior to the issuance of this policy."
- "The decision whether to engage in offsets, and the responsibility for negotiating and implementing offset arrangements, resides with the companies involved."
- "Any exception to this policy must be approved by the President through the National Security Council."

Federal and Defense Acquisition Regulations

Generally, government-to-government foreign military sales acquisitions are conducted under the same acquisition and contract management procedures as other defense acquisitions in Federal Acquisition Regulation (FAR) Part 31, "Contract Cost Principles and Procedures." However, the Defense Federal Acquisition Regulation Supplements (DFARS) Subpart 225.73, "Acquisitions for Foreign Military Sales," contains additional policies and procedures for government-to-government foreign military sales under the Arms Export Control Act. These regulations do not apply to direct commercial military sales contracts between U.S. contractors and foreign governments.

Our analysis of the federal acquisition regulations as they apply to offsets and costs associated with offsets follows:

- FAR Part 31 discusses allowability of various costs in government contracts. However, it does not specifically address the treatment of all types of costs associated with offsets.

- FAR Part 31 permits costs associated with marketing and negotiating offsets to be included in U.S. government contracts if they are considered selling costs.[2]
- Contractors' offset costs, along with other costs and risks, can be considered in the negotiation of the profit rate on a foreign military sales contract. Profit rates on direct commercial contracts are not subject to regulations.

We reviewed the history of changes to DFARS as follows:

- DFARS Subpart 225.73, dated 1988, allows U.S. firms to recover costs associated with the implementation of DOD offset arrangements.
- According to Defense Contract Audit Agency guidance dated 1989, because offset administrative costs are incurred as a direct result of foreign military sales contracts, these costs are allocable only to the benefiting foreign military sales contracts. These costs are not to be charged to indirect expense pools and allocated to domestic business. This guidance does not apply to direct commercial sales contracts.
- DFARS Subpart 225.73 was revised in 1991 making costs associated with the administration of offset agreements between contractors and foreign governments allowable costs.[3] The regulation does not specify types of offset administrative costs that would be unallowable. The DOD contracting officer is to determine the reasonableness and allocability of offset administrative costs.
- Under the Defense Security Assistance Agency (DSAA) policy dated 1991, offset administrative costs may be included only in foreign military sales wholly financed with cash. This policy was later changed to allow these costs in foreign military sales financed with FMF loans. The policy states that no FMF grant funds may be used to pay for these costs.[4]

[2]Prior to revisions adopted in April 1991, the FAR specifically provided that the costs of direct selling efforts in connection with foreign military sales or other foreign sales of military products or services were unallowable on U.S. government contracts.

[3]Examples given for offset administration costs include (1) in-house and/or purchased organizational, administrative, and technical support, including offset staffing, broker/trading services, legal support, and similar support activities; (2) offshore operations for technical representative and consultant activities; (3) marketing assistance and related technical assistance; (4) employee travel and subsistence costs; and (5) taxes and duties.

[4]During the course of our review, we pointed out to DSAA that it had allowed U.S. contractors to recover these costs in a sale financed with both FMF grants and repayable loans. Subsequently, the agency (1) changed the financing to ensure that only FMF loans funded the purchase and (2) established a procedure to ensure that FMF grants are not used to fund purchases allowing the recovery of offset administration costs.

- A proposed 1994 revision to DFARS Subpart 225.73 would allow U.S. defense contractors to recover administrative offset costs if the foreign military sale is financed wholly with customer cash or repayable FMF loans.

Views of Department of Defense Officials and U.S. Contractors and Our Response

Views of Department of Defense Officials and Our Response

In discussing the contents of a draft of this report, officials of the Office of the Under Secretary of Defense for Acquisition and DSAA stated that the Department of Defense (DOD) was complying with existing legislation and all DOD policies and regulations pertaining to offsets arising out of government-to-government and direct commercial sales to FMF recipient countries. We agree that DOD is complying with existing laws, policies, and regulations because the exception in the President's April 1990 offset policy allows the use of U.S. government funds to finance offsets in security assistance transactions, since this was part of the policies and procedures in place at the time. Additionally, federal acquisition regulations do not apply to direct commercial sales contracts funded by FMF grants and loans.

These officials also emphasized that to some extent, offsets in sales financed with FMF funds support U.S. foreign policy and security objectives. They noted, for example, it may be in the U.S. interest for aid recipients to build strong defense industries. We acknowledge their perspectives but note there is overcapacity in global defense production and the downsizing of the defense industry is costing many jobs. We further note that section 42 (a) of the Arms Export Control Act provides that, in using foreign national funds, special emphasis shall be placed on procurement in the United States, but allows for coproduction and licensed production when it best serves U.S. foreign policy, national security, and the economy of the United States. Further, sections 42 (b) and (c) of the Arms Export Control Act provide that FMF grants and loans are generally to be used by foreign countries to purchase military goods and services from the United States.

These officials further stated that coproduction activities associated with foreign military sales are not always offsets.[5] However, they acknowledged that the coproduction activities included in the contracts we reviewed were conditions of the sale, and therefore, these coproduction activities should be considered offsets.

These officials questioned whether the U.S. FMF program—particularly the grant aid element—is unique in the world, and no other arms supplier has a program that provides a combination of grant aid and offsets. We verified our information and found that no other arms supplier provides a combination of grant aid and offsets to compete in the world market. Instead of grant aid, other arms suppliers will generally provide actual

[5]For example, DOD officials stated that the U.S. and foreign governments will sometimes enter into co-development efforts.

military items to the recipient country or low interest loans so that the country can later purchase the military items from the supplier.

According to these officials, the U.S. government was not engaged in providing offsets to FMF recipient countries. We agree that DOD's policy is not to enter into offset arrangements because of the inherent difficulties in negotiating and implementing such arrangements. However, U.S. contractors contacted during our review informed us that the U.S. government made the decisions allowing coproduction in FMF recipient countries. In addition, DOD specifically agreed in its government-to-government agreements to coproduction and designated work offshore. These arrangements were conditions of the sales or offsets required by the FMF recipients.

Finally, these officials stated that a prohibition on the use of FMF grants to pay for or request offsets appeared reasonable. However, they did not believe that such a prohibition should apply to FMF loans. Furthermore, they did not believe that the prohibition could be easily or effectively enforced. We believe a certification requirement, if properly implemented, could be enforced. In addition, if it is made a condition of the grant aid, compliance could be checked.

U.S. Contractors' Views and Our Response

Generally, most U.S. contractor representatives we met with acknowledged that they are competing only with each other for grant-funded foreign military sales. Some contractor representatives, however, stated that offsets in FMF-financed transactions build their international business. These representatives expressed some concerns over a prohibition on offsets in FMF-financed sales.

Contractor representatives noted that France, Germany, the United Kingdom, and other countries help their defense industries compete by providing offsets and financing assistance such as guaranteed loans. We agree, but also note that, according to knowledgeable DOD officials, no other country competing with the United States has a similar program combining grants and offsets.

Contractors were concerned about a prohibition on obtaining offsets using FMF loans, because the recipients repay these loans with their national funds. We agree that FMF recipient countries intend to repay FMF loans with their national funds. However, some loans have been provided at concessional rates, or have been forgiven at a later date.

The contractors we contacted noted it would be extremely difficult to enforce a proposed prohibition on offsets using FMF grant funds. A U.S. company could make an investment in or purchase from a FMF grant recipient country and claim it was not to perform an offset obligation when it really was. To ensure enforceability, contractors could be required to certify that they have not and will not provide offsets in connection with grant-funded sales. Certain contractor representatives noted that the United States could also include as a condition of grant aid a prohibition on recipients requiring, requesting, or obtaining offsets. We agree and have adjusted our matters for congressional consideration section accordingly.

One company asserted that a prohibition on offsets may prompt FMF grant recipients to decide that they would rather use national funds or loans or other favorable financing and purchase from non-U.S. suppliers offering offsets. They noted this would result in loss of more business than with offsets. We believe that foreign countries would not likely refuse to use FMF grant aid in favor of spending their own money for comparable foreign products to obtain offsets.

One U.S. contractor was concerned that it would not be able to buy from or invest in FMF grant recipients' industries when it made good business sense to do so. We note the proposed prohibition does not preclude contractors from buying parts offshore when they are price, quality, and delivery competitive. It merely removes the offset obligation from the contractor's procurement decision-making process. Contractors told us that if all other things were equal between a U.S. supplier and a foreign supplier from a country to whom they owed offsets, they would select the foreign supplier to satisfy the offset obligation.

Objectives, Scope, and Methodology

At the request of the Chairwoman, Subcommittee on Commerce, Consumer Protection, and Competitiveness, House Committee on Energy and Commerce Committee, and Senator Feingold, we began evaluating offset arrangements and their legal implications. In 1992, the government of Finland, using its own funds, purchased the F/A-18 aircraft from McDonnell Douglas. McDonnell Douglas's offset commitment was shared with three other companies principally benefiting from the sale. Under the offset arrangements, one company offered to provide a 3-percent cash rebate (a third-party incentive payment) to selected U.S. companies that would purchase products from Finnish manufacturers. This cash rebate, however, adversely affected a U.S. company that was competing for a paper-making machinery sale with a Finnish manufacturer. To preclude U.S. defense contractors from making these types of payments in the future, Senator Feingold proposed and the Congress passed legislation that, among other things, prohibits the use of third-party incentive payments by U.S. contractors to satisfy offset obligations.

The congressional requesters also asked us to determine if U.S. government funds were used to pay for offsets from U.S. contractors and to evaluate offset arrangements arising out of the U.S. FMF Program. Specifically, our objectives were to (1) determine the nature and extent of offsets required by and provided to the four largest recipients of the FMF program in connection with purchases of U.S. military goods and services; (2) determine whether and how the U.S. government paid for offsets and their costs; (3) analyze applicable laws, policies, and regulations with respect to offsets; and (4) make observations on the impacts of offsets on U.S. employment, trade, and industrial competitiveness. In addition, we inquired as to whether other foreign countries such as the United Kingdom, France, and Germany provide a program similar to the FMF program to support military exports. We did not examine offsets associated with purchases made by foreign governments with their own national funds.

We performed our work at DOD organizations and three U.S. contractors selling U.S. military goods and services to Israel, Egypt, Greece, and Turkey. We interviewed DOD officials, reviewed legislation and policies, and analyzed supporting documents provided by the Defense Security Assistance Agency's Office of the Comptroller and Operations Directorate, the Air Force's International Affairs Office, the Air Force's Aeronautical Systems Center, and the Defense Contract Audit Agency. The three U.S. contractors were selected based on FMF sales made through government-to-government and direct commercial channels to Israel, Egypt, Greece, and Turkey.

Our work focused primarily on offsets associated with 48 contracts valued at $11.6 billion to sell U.S. weapon systems and other items to the 4 countries. First, we determined whether the four countries were using FMF funds (grants or loans) or national funds to acquire U.S. military goods and services. Second, by selecting large government-to-government and direct commercial sales using FMF funds, we identified three U.S. contractors involved with these sales. Third, we identified other sales made by these U.S. contractors to the four countries that included or involved FMF funds. Finally, to determine what offset obligations were required in connection with the various FMF sales, we obtained documentation and discussed the offsets with U.S. contractor officials.

Our selection of cases represents a small percentage of military sales to the four countries. Therefore, the results of our work cannot be projected to a larger universe of military offset arrangements.

To determine whether the U.S. government paid for offsets or their costs, we analyzed federal and defense acquisition rules to determine which types of costs associated with offsets are allowable and can be charged to the contract. In addition, we interviewed U.S. contractor officials and analyzed supporting documentation to determine how they accounted for the actual costs of their offsets as well as the administrative offset costs incurred to satisfy the offset obligations.

The impacts of offsets on overall U.S. employment are difficult to assess. To the extent possible, we made observations on the impacts of offsets on U.S. business, trade, and industrial competitiveness. The full extent to which foreign suppliers have actually displaced U.S. suppliers cannot be accurately measured because of the lack of data on the universe of offsets, previous and current suppliers, and other needed information. Nevertheless, to obtain anecdotal information on this matter, we selected items identified by the prime contractors as subject to coproduction and buyback arrangements for which they received substantial offset credit or which were bought back in large quantities. We then identified the previous or current U.S. suppliers and solicited their views and information regarding the impacts of these offsets on their business.

We also interviewed DOD and U.S. contractor officials to determine whether countries such as the United Kingdom, France, and Germany have programs similar to the FMF program to support military exports. To the extent possible, we reviewed supporting documentation provided by the officials.

We analyzed pertinent sections of the Foreign Assistance Act, the Arms Export Control Act, the Defense Production Act of 1992, the Federal Acquisition Regulation and the Defense Federal Acquisition Regulation Supplements to determine whether and how they addressed offsets with FMF grants and loans.

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