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FOR RELEASE ON DELIVERY
Expected at 10:00 a.m.
Thursday, October 10, 1985

STATEMENT OF
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BEFORE THE
COMMITTEE ON ENERGY AND COMMERCE
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS
HOUSE OF REPRESENTATIVES
ON
FOREIGN MILITARY SALES AND OFFSETS

Mr. Chairman, Members of the Subcommittees:

I am pleased to be here today to discuss offsets associated with U.S. overseas sales of military equipment. Over the past few years, we have issued several reports dealing with offsets, and coproduction programs. In these reports we raised questions about the impact of these arrangements, and the U.S. policy for coping with foreign country demands for increasingly large offsets.

Today I would like to focus my remarks on three main points.

- First, offsets arrangements are not new. They are, and will likely continue to be, facts of life in international trade--both in the military and much larger civilian trade sectors. In a 1984 report, we stated that demands for offsets on weapons sales would increase. What we have learned since then confirms our view.

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- Secondly, I would like to discuss how certain national interests may be affected when a U.S. firm makes an offset commitment to a foreign government as a condition for the sale of U.S. defense articles. In our earlier reports we found that no single agency comprehensively monitors offset activities, and that no mechanism exists for incorporating the views of all key U.S. government agencies and private industry in major offset decisions. The situation remains much the same today, although some steps have been taken to increase knowledge of these activities.
- Thirdly, I want to focus specifically on foreign buyers requiring offsets in cases where U.S. credit financing-- or in some cases grant financing--is used to purchase defense systems. In effect, this could amount to a double benefit to the foreign buyer.

But before we get into these points, some background and definitions are in order.

DEFINING OFFSETS

Unfortunately, the concept of offsets lacks uniform definition, and a variety of terms are used by different government and business entities to describe the same phenomenon. Today, I will be using the term "offsets" to refer to trade arrangements made as conditions of foreign military sales. Essentially these are arrangements intended to reduce the impact of costly weapons purchases on the buyer's balance of payments, or to provide the buyer with other advantages.

Offsets can take many forms and are usually categorized as either direct--that is, related to the weapon system being bought--or indirect--related to other products or services. Coproduction and licensed production, which involve production of part or all of a weapon system in the purchasing country, are the major forms of direct offsets. Other forms of offsets include subcontracting in the buyer country, transferring technology, investing in the buyer country and/or purchasing and marketing goods and services unrelated to the weapon systems being acquired.

From industries' perspective, it is usually preferable to sell outright, with no obligations to share production or technology or to commit to make purchases from a buyer. Notwithstanding, U.S. contractors are willing to enter into offset agreements because they are considered necessary to compete for and win sales. Essentially, offsets are viewed as marketing tools to help gain sales which otherwise might be lost. In addition, DOD and State support certain coproduction or licensed production agreements because they foster NATO standardization and enhance national security interests.

From the buyer's perspective, offsets are very attractive. Offsets reduce the impact of very expensive acquisitions on balance-of-payment positions, provide valuable technology and manufacturing know-how, support domestic employment, and create or expand independent defense industries. With these advantages, buyers may overlook some drawbacks. For instance,

coproduction is an inefficient use of defense resources, because it increases unit costs. As an example, even though Japan has limited its defense spending to one percent of its GNP, it has been willing to spend two to three times more to coproduce some defense items rather than buy them off the shelf.

U.S. EXPERIENCE

For decades, DOD has encouraged coproduction and other types of defense industrial cooperation programs to (1) enhance the national security of friendly countries, (2) promote equipment standardization and interoperability among allies, and (3) reduce redundant research and development. The hardware produced ranged from rifles, ammunition, and howitzers to tanks, ships, missiles, and aircraft.

Coproduction arrangements can vary. In one type of coproduction program, the U.S. supplier shares production and sales of the end items with the participating countries. For example, one of the largest coproduction programs--the purchase of the F-16 by Norway, Denmark, Belgium, and the Netherlands, known as the European Participating Governments (EPG)--involved a contract worth \$2.8 billion (January 1975 dollars). The intention was to facilitate NATO rationalization, standardization, and interoperability by inducing the selection of the F-16 as a replacement fighter aircraft for the NATO consortium countries. Offsets included the EPG coproducing 10 percent of the value of the initial U.S. aircraft buy, 15 percent of the value of all third-country buys, and 40 percent of the value of the EPG buys.

Another type of coproduction program involves licensing the production of components of the end-item only for the purchasing country's own defense forces' consumption. An example of this form is the F-15 venture with Japan.

According to DSAA, some recent examples of coproduction sponsored or licensing approved by the U.S. government include:

PATRIOT Air Defense System with Japan, Germany, and The Netherlands;

AIM-9L missile with Japan,

F-18 aircraft with Australia, Spain, and Canada.

In the past, coproduction or licensing of high technology items was largely confined to the industrialized nations. Less developed countries coproduced items at the lower end of the technology scale, such as the M-16 rifle by Singapore, South Korea, and the Philippines. Increasing demands are arising from developing countries for coproduction or licensed production of higher technology items, such as coproduction of the F-16 with Turkey, Israel, and South Korea. The concern is that these countries are developing defense industries which may later compete with U.S. defense industries. Many people in and out of government are concerned that this aspect is not fully considered in coproduction decisions.

The seemingly increasing popularity of indirect offsets is causing additional concern. Indirect offsets involve the direct purchasing and/or marketing of the buyer's civilian or defense goods--which are unrelated to the military equipment being

purchased. According to a variety of sources, U.S. defense contractors have either bought or marketed in the United States under indirect offset obligations such products as office furniture and equipment, textile products, cosmetics, radio and television receiving equipment, chemicals, and aircraft parts. Indirect offset obligations are not limited to "moving" commodities. U.S. defense contractors have agreed to promote tourism and set up manufacturing concerns in buyer countries sometimes valued at hundreds of millions of dollars per defense sale. The concern here is that other industries may be adversely affected by the marketing strategies of defense contractors.

For example, when buying U.S. aircraft in the late 1970s and the early 1980s, in addition to licensed coproduction, Canada required indirect offsets including U.S. contractor purchases of Canadian-built components for other planes and other industrial benefits to Canada. In addition, the U.S. contractors agreed to promote travel and tourism in Canada. In the sale of one aircraft, the F-18, the offset commitments totalled more than 100 percent of the sales value.

In another example, Saudi Arabia's \$3.7 billion Peace Shield air defense and communications project involves several offset programs resulting in U.S. technology transfers. Of the \$3.7 billion, some \$1.2 billion is to be tied to offset obligations fulfilled by a Boeing-led consortium, largely in the area of direct investment in viable manufacturing concerns in Saudi Arabia, preferably high-technology related.

One additional example--in the sale of the F-18 to Spain--McDonnell Douglas agreed to market Spanish exports, promote tourism, and provide for other indirect offsets, totalling about \$1.3 billion.

Many countries have policies or legislation seeking or requiring offsets on military purchases. For example, South Korean policy requires a minimum of 50 percent offsets for imports over \$1 million with a minimum of 20 percent being direct offsets with technology transfer. Australia has an offset requirement policy of at least 30 percent and is considering increasing the policy to 40 percent. The Israeli government has a policy of requesting U.S. suppliers to offset or "buy back" from Israel goods or services. To enforce their policies, some countries currently incorporate penalty clauses in contracts with U.S. companies in the event that their offset commitments are not met. Also being considered is the idea that companies which have not fulfilled previous offset agreements will not be eligible for new contracts.

U.S. GOVERNMENT ROLE

While "buyer" nations have specific policies regarding offsets, the United States as a predominant seller of military hardware lacks a comprehensive approach to managing offsets. The government takes no active role in administering offset transactions, and no agency monitors offset activity. Furthermore, there is no mechanism for assuring that views of the Departments of Commerce and the Treasury and the Office of

U.S. Trade Representative are considered when a U.S. firm makes an offset commitment. For DOD's part, since 1978 its stated policy has been not to become involved in negotiating or guaranteeing indirect offset agreements. In DOD's stated view, offsets are generally the responsibility of the contractor. DOD, however, is heavily involved in negotiating government-to-government coproduction agreements, which may often be a condition of the sale.

Opinions vary greatly as to the effects of offsets. Supporters of offsets claim that such arrangements can benefit U.S. national defense interests through commonality of weapon systems, create closer ties with friendly countries, lower unit costs, and generate or retain U.S. jobs (because without offsets, sales otherwise would not be made). On the other hand, critics maintain that foreign government-mandated offset agreements can erode the subcontractor industrial base, develop future competitors, create unemployment in and competition for unrelated industries, and subsidize inefficient foreign industry.

In a 1982 report, we pointed out that Japan used technology and manufacturing know-how gained in military coproduction to enhance its civil aircraft industry. When Japan was coproducing the F-15 aircraft, the Government of Japan was also assisting in the development of its civil aircraft industry. Although performance requirements for military and civil aircraft differ, development and manufacturing techniques are closely related and

technological spinoffs can be anticipated. For example, composites, avionics, instrumentation, and propulsion technologies transferred through the F-15 program could be applied to civil aircraft production. Many U.S. government and industry representatives were concerned that Japan could use this technology to help become a competitor in the world civil aircraft market. Japan is currently participating with Boeing in producing the 767 commercial aircraft, and should be considered a likely participant in the next generation commercial transport.

In our 1982 report, we concluded that the United States had not devoted adequate attention to the economic implications of military coproduction. We recommended that Defense and State coordinate with the Departments of Commerce, the Treasury, Labor, and the Office of the U.S. Trade Representative when considering coproduction requests involving high technology items. The other agencies generally agreed with the need for more interagency coordination, but DOD stated that the present system was working adequately.

One of the major stumbling blocks to assessing the potential impacts of offset arrangements is the dearth of information on the nature and scope of these activities. DOD's 1983 coproduction study estimates that about \$30 billion in potential arms sales during the period 1983-88 would involve offsets.

In our April 1984 report we had pointed out that while several U.S. government agencies had been studying the effects

of offsets on various national interests, their efforts remained insufficiently coordinated. Since that time, two major U.S. government efforts have been undertaken to determine how extensive offset arrangements are and to ascertain their potential impact on the United States. First, in 1984, the Congress passed legislation (section 309 of the Defense Production Act) requiring the President to report on the impact of offsets on U.S. defense preparedness, industrial competitiveness, employment, and trade. Although the law requires that this report be completed by October 17, we understand an extension of time has been requested. In addition, the International Trade Commission (ITC) has also completed its own assessment to determine the extensiveness of offsets or countertrade in both military and civilian sales. The ITC study is due out soon.

Both studies may make major contributions to the understanding of this complex subject. But, in our opinion, they are not substitutes for a continuing mechanism to collect and analyze data. Without a valid and comprehensive data base, it would be difficult to determine the impact of offsets, and it would limit the ability of the Departments of Commerce and the Treasury and the U.S. Trade Representative to participate effectively in important offset decisions.

OFFSETS INVOLVING
U.S. FINANCING

One last concern which we believe warrants additional attention involves allowing offsets in transactions which are financed with U.S. government assistance. Some of the countries

now requesting direct and indirect offsets--such as Egypt, Greece, Indonesia, Israel, South Korea, Spain, Pakistan, Turkey--are also receiving financing assistance. In our 1984 report on offsets we took the position that offsets should generally not be used when Foreign Military Sales (FMS) credits are involved.

DOD's policy is that FMS credits may not be used to directly finance coproduction or licensed production as a condition of sale. Thus, use of FMS credits to pay for the components produced in the foreign purchasing country is not normally permitted. DOD will, however, permit credits to be used for the portion of the end item that is produced in the United States. Regarding indirect offsets, DOD's stated policy is to discourage credit financing for purchases containing indirect offset provisions. DOD, however, is not a party to indirect offset arrangements and these are difficult to control.

Defense Security Assistance Agency (DSAA) officials told us that, since June 1984, FMS credits had not been used to finance mandatory direct offsets--with the exception of Israel. DOD, however, allows credits to be used in other ways to finance foreign production. For example, under a defense industrial cooperative agreement, Turkey will coproduce helicopters using credits. Also credits may be used to pay for items which include up to 49 percent foreign content, thus allowing contractors to subcontract overseas. Furthermore, credits may be used to finance U.S. origin tooling, technical data packages, and licenses. We have not determined the extent of these

practices or the extent to which they are being required as a condition of a sale.

Turkey's coproduction of the F-16 aircraft is a good illustration of how these policies work in practice. Turkey, which received \$700 million in grants and credits in FY 1985, expects to coproduce portions of 152 of the 160 F-16s it is purchasing with both FMS credits and its own funds. The credits can be spent on the U.S.-produced portions of the aircraft, and Turkey will use its own cash to pay for items produced in Turkey. However, Turkey does not yet have the capability to produce its share of the aircraft. Turkey may use FMS credits for any tooling, licenses, and technical data packages of U.S. origin--in other words, credits can be used to help establish a production capability. Furthermore, as part of the offset package, the U.S. contractor has agreed to invest in the Turkish aerospace industry.

Over the past several years, Israel has had the bulk of its loan repayments waived and has also been active in obtaining offsets--both direct and indirect. For example, in FY 1985 the United States permitted up to \$200 million of FMS credits to go toward direct offsets through subcontracting in Israel. Israel also is coproducing about \$300 million in components in its second buy of F-16s. Furthermore, we were told by DSAA that most Israeli purchases receive a 10 to 15 percent indirect offset with a penalty clause for non-performance.

A good example of use of indirect offsets by a credit recipient involves the potential sale of F-16s to Greece, which

is currently being considered by the Administration. Greece is seeking indirect offsets for this purchase. Industry proposals for meeting this requirement include investments in problem industries, technical assistance, aid in expanding Greece's aerospace sector, technology transfers, export sales of Greek products targeted by the Government of Greece, and tourism promotion.

One final example demonstrates a rather unique effect of negotiated offset agreements. As I discussed earlier, the F-16 arrangement with the four European countries involves their coproducing 15 percent of the value of all third-country buys. As things turned out, the F-16 has been sold to a number of countries which received U.S. financing assistance (and, in the case of Israel and Egypt, forgiven loans). Thus even though the United States is subsidizing the sale, and in some cases giving aircraft away, the United States is still obligated to give 15 percent of the production to the European nations. To us, this suggests the need for careful consideration of terms of future co-production and offset agreements.

This concludes my prepared remarks. I would be happy to answer any questions you might have.

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