

GAO

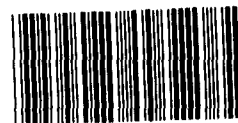
United States General Accounting Office

Report to the Chairman, Committee on
Foreign Relations, U.S. Senate

May 1991

ISRAEL

**U.S. Military Aid Spent
In-Country**



143973

National Security and
International Affairs Division

B-243241

May 23, 1991

The Honorable Claiborne Pell
Chairman, Committee on Foreign Relations
United States Senate

Dear Mr. Chairman:

The United States has authorized Israel to spend an increasing amount of U.S. military aid in Israel. In fiscal year 1990, Israel spent about 25 percent of its \$1.8 billion in military aid in Israel on what is termed offshore procurements. Because of congressional interest in accountability for foreign aid, we reviewed Israel's expenditures for offshore procurements to determine (1) whether the executive branch had observed the legislative requirements governing these procurements and (2) what effects these procurements have had on Israel's military budget and domestic economy. As requested by your office on January 22, 1991, we are reporting to you the results of our review.

Background

The offshore procurement program was established in fiscal year 1984 to fund Israel's development of the Lavi fighter aircraft. Although U.S. military aid to foreign recipients is generally required to be spent in the United States, Congress can make exceptions through legislation, and the executive branch can authorize the expenditure of these funds outside the United States on a case-by-case basis. Both methods have been used to allow Israel to spend military aid on offshore procurements.

For fiscal years 1984-91, Congress earmarked almost \$2.8 billion in Foreign Military Financing (formerly known as Foreign Military Sales) funds for offshore procurements in Israel. The amount earmarked for these purchases increased from \$250 million in 1984 to \$475 million in 1991. Since the cancellation of the Lavi program¹ in 1987, the program's purpose has been modified as follows:

"...That to the extent that the Government of Israel requests that funds be used for such purposes, grants made available for Israel by this paragraph shall, as agreed by Israel and the United States, be available for advanced fighter aircraft programs or for other advanced weapons systems [emphasis added], as follows: (1) up to

¹Foreign Assistance: Analysis of Cost Estimates for Israel's Lavi Aircraft (GAO/NSIAD-87-76, Jan. 31, 1987) and Foreign Assistance: U.S. Funds Used for Terminating Israel's Lavi Aircraft Program (GAO/NSIAD-90-3, Oct. 26, 1989).

\$150,000,000 shall be available for research and development in the United States; and (2) not less than \$475,000,000 shall be available for the procurement in Israel of defense articles and defense services, including research and development."²

Under section 42(c) of the Arms Export Control Act, the executive branch can also approve the use of U.S. military aid for offshore procurements if it determines that the acquisition is not detrimental to the U.S. economy or the industrial mobilization base. As a result of section 42(c) rulings, Israel was granted \$90 million for jet fuel and \$75 million for unspecified purchases in addition to the amount authorized by Congress.³

The Defense Security Assistance Agency (DSAA) administers Foreign Military Financing funds and oversees all Israeli purchases with these funds, including those outside the United States. Israel notifies the United States in advance of the purchases it plans to make in-country, and Israel's Ministry of Defense oversees in-country contracts and payments. DSAA requires that Israel provide contractor certification of the value of foreign (non-U.S. and non-Israeli) components that are not eligible for U.S. financing. Israel pays its contractors in local currency and is reimbursed by DSAA for eligible costs in U.S. dollars, a "hard currency."

Results in Brief

DSAA has not observed the legislative requirement that offshore procurement funds be used for the development and production of advanced weapon systems. During fiscal years 1988-90, Israel was reimbursed for fuel, maintenance, and ammunition. DSAA believes that the law is ambiguous about what items qualify for offshore procurement funding. In the absence of clear legislative intent, DSAA has adopted a flexible approach toward offshore procurement which is tantamount to a cash transfer program. This approach reimburses Israel for defense items that we believe the law does not allow. Furthermore, unlike other U.S. programs such as the Economic Support Fund, there is no requirement for Israel to account for the hard currency provided for offshore procurements.⁴ Thus, the United States has not overseen the use of the dollars to ensure

²Foreign Operations, Export Financing and Related Programs Appropriations Act, 1991 (P.L. 101-513).

³The executive branch authorizes funds for offshore procurements under section 42(c) of the act when it is exceeding the amount specified in appropriations acts.

⁴The Economic Support Fund, administered by the Agency for International Development under the general policy direction of the Department of State, is designed to promote economic or political stability in areas where the United States has special security interests.

that such funds are used only for purposes that support U.S. domestic and foreign policy interests. Although GAO recognizes that dollars provided under offshore procurement are fungible, shifting the funds made available under offshore procurement to the Economic Support Fund program would put all cash transfers under a single program.

We could not isolate the effects of offshore procurements on the Israeli defense budget; however, we noted the following:

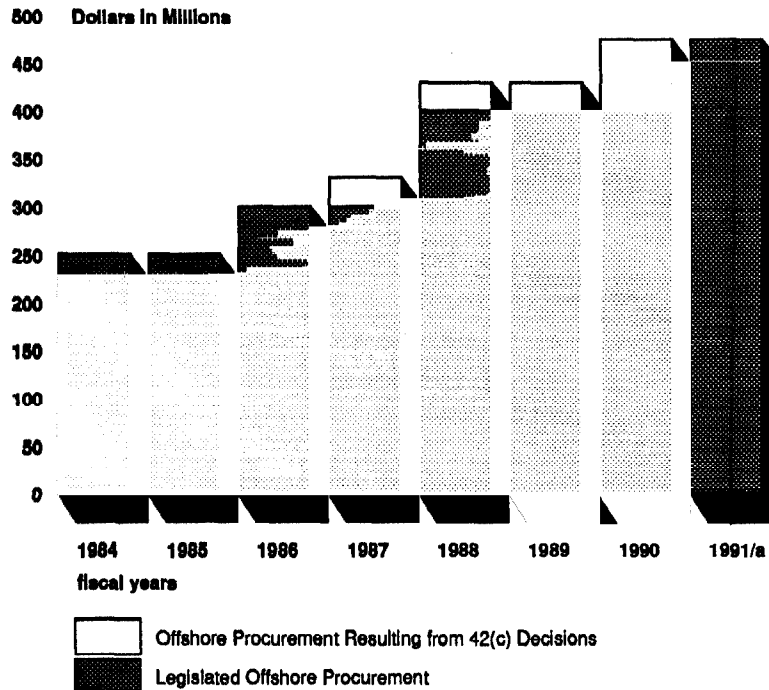
- Although offshore procurements have decreased the amount of U.S. military aid Israel spent in the United States, they have not increased Israel's domestic defense spending by an equal amount. According to officials in Israel's Ministry of Defense, Israel's domestic defense budget would decrease without offshore procurements but not by the full amount. Some domestic defense spending attributed to offshore procurements would occur with or without U.S. offshore procurement funding.
- Although Israel's demand for U.S. systems is increasing, Israel is spending an increasing amount of U.S. military aid outside the United States on offshore procurements.
- Offshore procurements benefit Israel's economy in two ways: (1) they generate hard currency, which helps support Israel's balance of payments and (2) they generate additional domestic spending and create jobs without increasing taxes or the government deficit.

DSAA Has Provided Limited Oversight of Offshore Procurements

After cancellation of the Lavi, the offshore procurement program was tied to no specific project and appeared to be operating as a cash transfer program. As such, oversight of the program was limited.

From 1984 through 1991, Israel had been given the authority to spend nearly \$3 billion of its military aid in Israel. Of this amount, \$165 million was granted under section 42(c). Figure 1 illustrates the annual offshore procurement levels for Israel.

Figure 1: Foreign Military Financing Funds Available for Use in Israel



Note: The dollar amounts have not been adjusted for inflation.

^aThe total amount of offshore procurement available to Israel could still be increased if any 42(c) determinations are made.

Over the years, Congress has continued to authorize offshore procurements, but has altered the scope of the program. The original offshore appropriation in 1984 was only for the Lavi program. The 1986 and 1987 appropriations acts expanded eligibility to "other activities if requested by Israel." Since fiscal year 1988, however, the legislation has included the term "advanced weapons systems" as a limitation on the program, and the phrase "other activities if requested by Israel" has been dropped. The legislative history does not clearly indicate why these changes occurred. However, DSAA does not believe these changes required them to modify their basis for approving projects for funding for two reasons. First, the phrase "defense articles and defense services", particularly "defense services", is broader than "advanced weapons systems" and can justify expenditures on services that are not necessarily associated with advanced weapon systems. Second, the legislation does not define advanced system and DSAA has permitted Israel to determine what procurements are covered.

We take a narrower view of the legislation and believe that only items associated with advanced weapon systems should be reimbursed. First, the appropriations language limits funding of offshore procurement to "advanced fighter aircraft programs" or "other advanced weapons systems." The term "defense articles and defense services" appears to be included in the limitation. Thus, only the cost of defense articles and defense services associated with advanced weapon systems can properly be reimbursed. Second, the legislation does not delegate the role of defining "advanced weapons systems" to Israel, but suggests that both Israel and the United States agree on which advanced weapon systems are to be funded within the program.

Although the Ministry of Defense has generally submitted vouchers that cite expenditures for technically advanced items as justification for offshore procurements, Ministry officials have tried to limit the number of items submitted to account for these funds because they are aware that DSAA has limited staff. Thus, more expensive articles and services that can be grouped as one item, such as ammunition and aircraft maintenance, are also used to account for the expenditure of offshore procurement funds. According to DSAA officials, Israel could probably submit sufficient vouchers for advanced weapons to justify the full amount spent for offshore procurements. However, the list of projects submitted for pre-approval would be longer and the process might be more burdensome for the Ministry and DSAA if more, smaller projects were submitted for financing approval. The articles and services for which Israel has requested reimbursement have simply been used as documentation to support disbursements.

Table 1 shows all activities and services submitted by Israel for reimbursement in fiscal year 1990.

Table 1: Offshore Procurement Funding and 42(c) Allocation for Fiscal Year 1990

Dollars in millions	
Program/Item	1990 costs
Sight pilot helmets	\$1.9
Merkava tank	76.8
Tank and armored personnel carrier upgrades	76.4
Popeye missile	8.4
"Gal" fire control system	4.4
Means for night vision	13.0
Search and rescue system	0.1
Phantom 2000 F-4 upgrade	8.9
DVORA boats	0.5
Evan Yekara communications facility	4.3
"SMART" artillery rangefinder	2.1
Tank protection	3.2
Harpy unmanned aerial vehicle	4.7
Pioneer remotely piloted vehicles	7.3
Peacemaker II/III aircraft systems and overhauls	14.4
Naval modernization	30.1
Means for minefield breaching	12.1
Military vehicle assembly	9.4
Fuel	33.1
Aircraft maintenance	119.8
Ammunition	43.9
Total	\$475.0

Note: Numbers may not add due to rounding.

If the purpose of offshore procurement is to improve Israel's qualitative advantage, we believe that only defense items meeting that purpose should be funded. Criteria that might be used in determining whether defense articles and services provide a qualitative edge could include whether the item (1) enhances the capability of an existing defense system, (2) appears to be technically superior to other systems in Israel's inventory, or (3) represents a significant element of an advanced system. We recognize that some ammunition and aircraft maintenance costs submitted for reimbursement may be attributed to advanced systems. However, our review of documents (either requests for funding approval or payment) submitted to DSAA from 1989 to 1990 shows that Israel was also reimbursed for a number of other defense articles that did not appear to be technically advanced, did not support advanced systems, or did not include sufficient data to make a determination. Some examples follow.

- Aircraft maintenance: \$211 million for various contracts, including the operation and maintenance of Piper and Tzoukit training aircraft, a large variety of maintenance work on systems/items,⁵ maintenance work on light aircraft and engines, painting of planes, and maintenance of cargo aircraft.
- Small arms and ammunition: \$104 million covering over 100 purchase orders for items such as spare parts and ammunition for rifles, ammunition for light mortars, ammunition for tanks, and other types of ammunition.
- Vehicle assembly: about \$36 million for the assembly of three-quarter ton trucks.

We believe that DSAA's approach has been to empower Israel to develop adequate controls to comply with the conditions of the aid. Aside from whether U.S. funding of certain projects should have been allowed, overall, Israel has instituted procedures to monitor the program. We did not test the reliability and adequacy of the documentation submitted to DSAA. However, according to DSAA, Israel has generally complied with DSAA requirements and provides additional clarification when needed. For example, the Ministry of Defense provided a cost breakout of the Merkava tank, as requested by DSAA. Further, the costs of foreign components not eligible for U.S. financing, such as components of the Pioneer remotely piloted vehicle and the sight pilot helmet system, have routinely been identified and excluded from requests for reimbursement. U.S. dollars, a hard currency, provided from offshore procurement could be available, however, to pay for the foreign components.

In addressing internal controls, we also examined U.S. oversight of the hard currency produced by the offshore procurement program. The administration has tried to ensure that U.S. funds have not been directly used for purposes that conflicted with U.S. interests. For example, the administration withheld \$400 million in housing loan guarantees to help settle Soviet immigrants until Israel provided technical data and clarification that the money would not be used to settle Soviet Jews in the occupied territories. Furthermore, when Israel was considering the purchase of a coproduced German-American combat system for Dolphin submarines, DOD said it would not reimburse Israel with Foreign Military Financing credits for costs incurred in Germany. DSAA's lack of oversight on the use of the hard currency provided from offshore

⁵Detailed examples are: "maintenance of hydraulic, pneumatic, and electro-mechanical assemblies for various aircraft", "maintenance of structure parts such as aircraft seats, running nets, etc."; and "maintenance of accessories and components, overhaul of blades and rotors, production and overhaul of electrical harnesses."

procurements appears inconsistent with other administration oversight efforts. For example, although the administration told Israel it would not reimburse them for costs incurred in Germany on the combat system contract, dollars transferred under the offshore procurement program could, in fact, have been available to pay these German costs.⁶

Effects of Offshore Procurements Are Difficult to Measure

The offshore procurement program gives Israel the flexibility to decide whether to purchase certain items in the United States or in Israel. Procurement decisions are driven not only by military requirements, but also by economic pressures. The Ministry of Defense argued that the two can not be separated.

Effects on Israel's Military Budget

One of the difficulties in evaluating the contributions of offshore procurements to Israel's military capability is determining how much Israel's domestic defense industry would diminish without it. In Israel's published 1990 defense budget, U.S.-funded offshore procurements comprised about 9.2 percent of its total domestic defense expenditures. Without it, maintaining the same level of domestic defense expenditures would add to Israel's deficit. This, in turn, could limit Israel's capacity to invest additional resources in its own defense industries. According to the Ministry of Defense, Israel's domestic defense budget would decrease without offshore procurements, but not by the total amount of the program. Budget cuts would be allocated across-the-board so that the defense budget would not absorb the total reduction.

A comparison of Israel's domestic defense expenditures before and after the offshore procurement program suggests that the program has had a limited impact on Israel's defense budget. In the 3 years before the program (1981-83), Israel's domestic defense expenditures as a percentage of its gross domestic product averaged about 12.1 percent. Since 1983 this percentage has steadily declined, falling to 8.2 percent per Israel's 1990 budget. Furthermore, some of the items Israel cited on vouchers for reimbursement would have been financed without offshore procurement funds (e.g., fuel, maintenance). A thorough analysis of Israel's

⁶The contract was ultimately cancelled; however, some termination costs may be paid to the German firm.

defense budget is complicated because portions of the budget are not listed in official documents.⁷

Offshore procurement funding has probably provided the Ministry of Defense increased leverage within its own government to obtain more funds for its defense budget. The increase in domestic spending has enhanced Israel's defense capacity. In the past, Israel might have purchased items from the United States because of the requirement that U.S. military funds be spent there even though the items were available in Israel at lower cost. The offshore procurement program gives Israel greater flexibility in allocating its U.S. military aid. Israel is not required to spend its total offshore procurement authority in Israel (i.e., the funds can be spent in the United States). However, we believe that the Ministry of Defense faces internal pressure to bolster Israel's economy by purchasing defense items in Israel rather than in the United States.

Offshore procurement funding has allowed Israel to maintain its defense industrial base,⁸ which promotes military self-sufficiency. Israel produces its own tanks (91 percent of the components are Israeli), patrol boats, sophisticated avionics, remotely piloted vehicles, missiles, and many other systems. Many nations, including the United States, purchase these systems.

Offshore Procurements Have Reduced Expenditures in the United States

Expenditure of U.S. military aid in Israel reduces expenditures in the United States at a time that the United States has a merchandise trade deficit with Israel.⁹ According to some State and DOD officials, if U.S. military aid were spent in the United States on advanced systems rather than in Israel it would go farther toward giving Israel the "qualitative edge" intended by U.S. policymakers. Because much of Israel's Foreign Military Financing is pre-committed, it has had to postpone or forego purchasing some systems from U.S. contractors. Specifically, Israel is only now beginning to purchase Apache helicopters, which they have desired for some time. Also, Israel was given Patriot missiles from U.S.

⁷The Ministry of Defense, although requested, did not provide greater detail on its defense budget, particularly the relationship between offshore procurement funds and domestic investment; therefore, additional analysis could not be performed.

⁸Israel's military industrial growth can also be attributed, in part, to "direct offsets", which allowed Israel to require U.S. contractors to purchase specific parts or materials from Israeli firms as part of their contracts.

⁹U.S. Controls on Trade with Selected Middle Eastern Countries, (GAO/NSIAD-91-193FS, April 12, 1991) p.25, table V.1.

inventories during the Gulf crisis that it could not previously afford to buy because of other defense budget commitments in Israel. While some portion of offshore procurement assists Israel's defense industries, it also reduces defense sales by U.S. firms. Some U.S. officials are concerned that the reduction of Israeli purchases in the United States is coming at a time when U.S. defense industries are losing other business as well.

Israel Has Derived Economic Benefit From Offshore Procurements

Clearly, Israel has benefited economically from the offshore procurement program. Offshore procurement has allowed Israel to maintain a higher level of spending and employment. Without offshore procurements, some domestic programs either would not have been funded or would have been scaled down. For example, according to Ministry officials, approximately 3,000 people have been employed in producing the Merkava tank and its components. The tank would still be produced without offshore procurement funds, but maybe fewer tanks would be produced and fewer people would be employed. According to a U.S. Embassy official, when the Lavi program was cancelled, Israel did not suffer militarily, as it was able to buy F-16 aircraft, but it lost hundreds of jobs. Some highly skilled workers chose to emigrate to work in other countries' aerospace industries. The loss of these workers was detrimental to Israel's economy.

The hard currency derived as a result of the offshore procurement program has improved Israel's balance of payments. However, if the program is tantamount to a cash transfer, it appears that a better way to transfer the dollars is through the Economic Support Fund rather than through the Foreign Military Financing Program. If the offshore procurement allotment were transferred from Foreign Military Financing into the Economic Support Fund, it would provide the same degree of budgetary support to Israel as offshore procurements currently provides. Although the Ministry of Defense might lose some leverage in promoting its defense budget, domestic defense expenditures need not change. The primary difference would be that under the Economic Support Fund program, Israel would have to account for its use of dollars. DSAA would not have to institute additional controls because it would no longer be responsible for disbursing the funds.

By agreement, the Economic Support Fund for Israel can only be expended in the United States for purposes agreed upon by the two governments as necessary for balance of payments. In 1990, both governments agreed to use the proceeds for purposes such as (1) financing the

importation of raw materials, capital goods and consumer goods; and (2) servicing external debt owed to or guaranteed by the U.S. government including Foreign Military Financing debt. Israel is required to maintain a separate bank account for cash transfer proceeds, retain financial documentation and submit quarterly reports concerning the use of the funds. These records must be made available to the United States for examination upon request.

Recommendations

Unless Congress changes the law governing offshore procurements for Israel, we recommend that the Secretary of Defense direct DSAA to

- define advanced weapon systems and limit funding to these systems,
- take a more active role in reviewing and approving projects for U.S. financing, and
- require Israel to account for the hard currency provided by offshore procurement.

Matters for Congressional Consideration

Congress may wish to reexamine the primary purpose of offshore procurements and consider choosing among the following alternatives:

- If the purpose of offshore procurements is to aid Israel in researching, developing, and procuring advanced weapons, the language in future appropriations need not change. DSAA would have to implement the above recommendations.
- If the purpose of offshore procurements is to support Israel's economy, the funds should be appropriated as part of the Economic Support Fund, eliminating the Defense Department's involvement in a cash transfer. Under this option, the Foreign Military Financing portion of Israel's assistance would decline while the Economic Support Fund level would increase by the transferred amount.
- If the purpose of military aid in general is to maximize Israel's defense budget, offshore procurements should be eliminated or phased out, and Israel should be required to spend all Foreign Military Financing in the United States. Offshore procurements could still be allowed for specific projects either by DSAA through the Arms Export Control Act (section 42(c)) or by specific congressional action. Congress could designate only certain offshore defense projects for full or partial funding, as it did with the Lavi. Under this option, no change would take place in the mix of assistance Israel currently receives.

Agency Comments

DSAA officials generally concurred with our findings and conclusions, with one exception. DSAA believes that reimbursement of any defense article or defense service of Israeli origin requested by that government is permitted by the appropriations act. Accordingly, DSAA believes it can reimburse Israel for all categories of expenses, including ammunition and aircraft maintenance, without distinguishing between those related to advanced systems and those that are routine. We believe that a more reasonable interpretation of the provision is that offshore procurement is intended to provide Israel an opportunity to develop advanced technology to enhance its qualitative edge. To accept DSAA's interpretation is to discount the changes adopted by Congress in the appropriations language that appear to establish eligibility requirements for offshore procurement. If Congress now agrees with DSAA that all items should be eligible for financing, then the offshore procurement funding is little more than a cash transfer program. As such, we believe it is more appropriate to transfer the funds to the Economic Support Fund, an established cash transfer program. DSAA officials do not oppose this idea.

Scope and Methodology

We interviewed key officials at the Departments of Defense and State; the U.S. Embassy, Tel Aviv; Israel's Ministry of Defense in New York and Israel; and selected Israeli contractors. We did not independently verify the accuracy of information obtained from Israeli sources.

Our fieldwork in Israel was performed in October 1990, and our review was performed from May 1990 to January 1991. Except as noted above, we conducted our review in accordance with generally accepted government auditing standards.

We are sending copies of this report to appropriate congressional committees and Members of the Congress; the Secretaries of Defense and State; the Director, Office of Management and Budget; and other interested parties upon request.

This review was performed under the direction of Joseph E. Kelley, Director, Security and International Relations Issues, who may be reached on (202) 275-4128 for further information. Other major contributors to this report were Louis H. Zanardi, Assistant Director; Diana M. Glod, Evaluator-in-Charge; and Hynek P. Kalkus, Evaluator.

Sincerely yours,



Frank C. Conahan
Assistant Comptroller General

Ordering Information

The first five copies of each GAO report are free. Additional copies are \$2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

**U.S. General Accounting Office
P.O. Box 6015
Gaithersburg, MD 20877**

Orders may also be placed by calling (202) 275-6241.

United States
General Accounting Office
Washington, D.C. 20548

Official Business
Penalty for Private Use \$300

First-Class Mail
Postage & Fees Paid
GAO
Permit No. G100
