

BY THE COMPTROLLER GENERAL

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**Report To The Committee  
On Foreign Relations  
United States Senate  
OF THE UNITED STATES**

RELEASED

**What Would be the Impact  
of Raising Or Repealing  
The Commercial Arms Sales Ceiling?**

Congress has prohibited the commercial sale of major defense equipment valued at more than \$35 million. Sales over that amount must be made through U.S. Government channels except for sales to the closest U.S. allies who were exempted from the requirement.

The ceiling has had a limited impact. Generally it has complicated firms' marketing/sales activities, but has had a direct effect on only a few manufacturers. Additionally, factors other than the ceiling tend to keep significant sales out of the commercial channel.

Elimination of the ceiling without enacting other controls would prevent Congress from exercising its oversight over a few types of sales now forced into the foreign military sales channel. GAO identified and analyzes a number of alternatives to the current ceiling.



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COMPTROLLER GENERAL OF THE UNITED STATES  
WASHINGTON, D.C. 20548

B-197130

The Honorable Frank Church  
Chairman, Committee on Foreign Relations  
United States Senate

Dear Mr. Chairman:

This report discusses the impact of raising or eliminating the \$35 million ceiling on commercial arms sales.

As you requested, we did not obtain official, written comments; however, we did discuss the draft with executive branch and industry officials and the report reflects their comments.

As arranged with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 7 days from the date of the report. At that time we will send copies to interested parties and make copies available to others upon request.

Sincerely yours,

A handwritten signature in cursive script, appearing to read "Thomas A. Staib".

Comptroller General  
of the United States

1992/10/10

1992/10/10

COMPTROLLER GENERAL'S  
REPORT TO THE COMMITTEE  
ON FOREIGN RELATIONS  
UNITED STATES SENATE

WHAT WOULD BE THE IMPACT  
OF RAISING OR REPEALING  
THE COMMERCIAL ARMS SALES  
CEILING?

DIGEST

A \$25 million ceiling on commercial arms sales enacted in 1976 was raised to \$35 million in 1979. The rationale for prohibiting significant commercial sales to all but the closest allies of the United States is that control and influence over sales would be strengthened by requiring direct U.S. Government involvement in these sales. However, the impact of the commercial arms sales ceiling has been limited.

The ceiling generally has complicated firms' marketing/sales activities but has had a direct effect on only a few manufacturers. Since significant sales traditionally have been on a Foreign Military Sales (FMS) basis it has not been an important factor in keeping such sales in the government-to-government channel. Nevertheless, some State and Defense Department officials continue to feel that the ceiling is necessary.

They believe it provides an opportunity for greater Government involvement in a sale from the beginning and that it acts as a deterrent, keeping significant sales to non-exempt countries out of the commercial channel. Other officials while agreeing that the United States should be involved in major sales disagreed with the assertion that FMS controls were significantly better or that the ceiling was forcing sales into the FMS channel.

GAO's conclusion is that if the U.S. Government is involved in a sale from the beginning, then it does in fact have more influence over the entire process. However, the ceiling does not guarantee such involvement.

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## FMS VERSUS COMMERCIAL

FMS and commercial are essentially two different contracting methods. Rather than negotiating price and delivery on its own (commercial), a foreign country may prefer to have the U.S. Government handle the contract terms (FMS). Statistics show that even before the commercial sales ceiling, the overwhelming majority of important sales to both exempt and non-exempt countries were on an FMS basis. All the significant commercial sales we examined were split sales with both FMS/commercial contracts involved. They were made with U.S. Government approval and often encouragement. Some of the customers believed that by using the commercial channel for a portion of the sale they saved money and/or ensured earlier delivery. Some of these sales were split because an important component of the system being purchased could only be sold on an FMS basis.

## CONTROLS OVER SALES

For the most part, the controls over arms sales do not distinguish between whether a sale is FMS or commercial. The same government offices review both commercial and FMS requests and apply the same criteria, including the President's arm transfer restraint policy. Some officials believe that the level of review and the degree of scrutiny are not as great for commercial sales. However, this is probably a reflection of the fact that most commercial sales are not that significant and that all important FMS sales are carefully scrutinized perhaps even at the Presidential level before being submitted for congressional review as required by section 36 (b) of the Arms Export Control Act. A control added in 1977 requiring firms to seek approval before promoting significant defense equipment should provide the Government with an opportunity to either prevent a sale or to stipulate that the sale be negotiated and implemented on an FMS basis.

The fact that most major defense equipment was designed for and purchased by the U.S. military pushes many sales into the FMS channel. Foreign countries rely on U.S. expertise in purchasing the equipment, which usually contains numerous components manufactured by a variety of companies. Some of these components may be cheaper if purchased through the U.S. Government because of quantity buys; some must be purchased through the FMS program because they are manufactured in a U.S. Government arsenal. Highly classified items also tend to be sold through FMS channels.

#### ALTERNATIVES TO THE CURRENT CEILING

There are two basic sets of alternatives to the current ceiling. One approach would be to substantially raise the ceiling or eliminate certain equipment from the ceiling limitation. Such action would correct the current situation where the ceiling is an unfair burden on a few companies. Another set of alternatives would be to eliminate the ceiling but subject significant commercial sales to congressional review. Language could be added which states a U.S. Government preference for FMS sales of major defense equipment but which does not require it.



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ABBREVIATIONS

ACDA Arms Control and Disarmament Agency - HSC 00450  
DSAA Defense Security Assistance Agency  
DOD Department of Defense  
FMS Foreign Military Sales  
GAO General Accounting Office  
GFF Government-furnished equipment  
ITAR International Traffic in Arms Regulations  
MDE major defense equipment  
NATO North Atlantic Treaty Organization  
CMC Office of Munitions Control

## CHAPTER 1

### INTRODUCTION

The following divergent views are representative of the wide range of opinion on commercial arms sales controls.

"The controls over commercial arms sales are an 'agony tree' with at least 42 different offices reviewing an export license request."

"The system of controlling the promotion of commercial arms sales is 'loose as a goose.'"

The company describing the "agony tree" sees the involvement of so many offices as overcontrol that creates slow, cumbersome selling and contracting processes. The other statement was made by a former Director of the Defense Security Assistance Agency (DSAA) during our earlier review.<sup>1/</sup> He felt that, without an active role in sales negotiations, the Government is left in the dark; yet, because of the type of equipment or the foreign policy implications of some sales, the Government should be deeply involved. We believe that while each statement has an element of truth, neither is an adequate assessment of commercial controls. In this report, we assess the impact of one control mechanism, the commercial arms sales ceiling, discuss the controls over sales, and identify some alternatives to the ceiling.

#### WHAT IS A COMMERCIAL OR FMS SALE?

What is the basic difference between a Foreign Military Sale (FMS) and a commercial sale? Essentially they are two different contracting methods. In an FMS sale, the Department of Defense (DOD) is authorized by the Arms Export Control Act, to play the role of a middleman between foreign governments and American manufacturers. If the U.S. Government approves an FMS purchase, it negotiates an FMS price and delivery schedule with the manufacturer. In short, the United States buys the equipment as if it were for U.S. Forces and sells it to the foreign government. The United States transfers the payment from the foreign purchaser to the manufacturer and collects an administrative fee from the former to cover costs.

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<sup>1/</sup>"U.S. Munitions Export Controls Need Improvement" (ID-78-62, Apr. 25, 1979).

In contrast, on a commercial sale, the U.S. manufacturer and foreign country negotiate the price and delivery schedule. Payments are made directly by purchaser to seller. The U.S. Government role is to approve (1) the manufacturer's request to promote or sell his product in the particular foreign country, and (2) an export license to deliver the equipment to that country.

Industry and government spokesmen frequently cited the following reasons why a purchaser would use the commercial channel: faster delivery; new equipment; flexibility to quote fixed price with penalty for late delivery; avoidance of FMS administrative fee; negotiate directly with manufacturer rather than through a middleman; less bureaucratic redtape; and support tailored to foreign countries needs.

Industry and government spokesmen frequently cited the following reasons why a purchaser would use the FMS channel: country pays lowest price U.S. Government can negotiate; expertise of U.S. military in recommending level of support and spares; assured right to purchase U.S. improvements to product; inspected to meet U.S. standard; able to buy into U.S. logistic support system; and trust for the U.S. Government. These are relative rather than absolute advantages and are not mutually exclusive. For example, a commercial price may be lower or FMS may offer better support. Three factors have the most influence on the purchase channel selected by a foreign country. These factors are price, time, and support.

The price of a particular item can vary significantly depending on the quantity purchased, level of production, production learning cycles, time of delivery, and configuration. These factors make it difficult to compare actual transactions to determine whether FMS or commercial prices are lower. Additionally, both industry and the U.S. Government tend to discourage cost comparisons. Nevertheless, we noted that frequently countries do shop for the best price, asking the United States for an FMS price and at the same time asking the manufacturer for a commercial price. U.S. companies pointed out that a commercial sales price may be lower than a corresponding FMS price because it avoids the Government's administrative charge and it is less likely to be affected by inflation due to the shorter commercial procurement cycle. Government officials, on the other hand, argue that if commercial prices are lower it is because they do not include adequate support or training. Additionally, they stated that companies make a larger profit on commercial sales than on FMS. Profits are limited to a fixed percentage on FMS sales

and are negotiated under Government regulations. Although U.S. companies readily admit the higher commercial profit margins, they point out that since the FMS service charge is based on a fixed percentage, the United States actually makes a profit on a high-dollar value FMS sale. Finally, they believe that higher margins are justified by the greater risks of doing business overseas and feel they are controlled by the market and competition, including the FMS channel itself.

Unlike the diversity of opinion about prices, most people agreed that delivery can be initiated earlier under commercial sales rather than FMS. Since production takes the same length of time, delays occur between the point of request and the signing of a contract. For commercial sales, the time from request to contract is 1 to 4 months; for FMS, it is 9 to 12 months. Most officials agreed that FMS takes longer because of the levels of review required in the Government and having to negotiate with two entities--the buying country and the U.S. manufacturer. Time becomes important in a purchase for several reasons, including immediacy of need, price, and continued availability of funds in a foreign country's fiscal process.

Spare parts and support equipment are essential to the continuing proper use of military equipment. Great differences can occur in the recommended levels of support and spares and the adequacy or ability of industry and Government to provide them. Several U.S. Government officials said that industry often does not recommend enough spares in order to entice the foreign country with a lower price. Companies, on the other hand, claimed the military recommended too high a level. Industry argues that a lower level of spares is feasible because they supply parts quicker, if necessary, than the military.

Three other factors can also play a part in a country's decision between FMS and commercial. The first is trust. The prior experience of the foreign country or stories about other countries' experiences can be a deciding factor. While foreign governments may not feel they have much clout in dealing with a U.S. company, FMS provides a clearcut channel to air complaints. As one company official put it, a foreign government knows it can "raise hell" about an FMS sale through diplomatic channels. At the same time, U.S. firms may encourage some countries to use FMS because of their lack of confidence in the countries' ability to pay or to be able to effectively negotiate a commercial contract. Secondly, some countries prefer FMS purchases because it demonstrates a political tie with the United States. Conversely, some countries, because of their political neutrality, prefer not to buy

through FMS. And, thirdly, worldwide competition in selling weapons has greatly increased. Companies told us that the controls placed on them in recent years, such as the ceiling, have made it more difficult for them to compete for both FMS and commercial contracts.

In response to the question of which contracting method is better, there is no clearcut answer. One customer may require quick delivery while another may be willing to wait longer in order to take advantage of a lower cost that results from the U.S. combining its own and foreign orders for the same equipment. At the beginning of this review, we shared with many others in Government and industry the view that commercial and FMS were separate and distinct channels. Upon closer inspection of specific sales, we learned that they are not. Sales which appear to be purely commercial may have FMS aspects and vice versa. Although straight commercial and FMS contracts do exist, the frequent combining of the two contracting methods in significant sales reflects the fact that the advantages of the two contracting methods are not absolute and tend to be offsetting. For example,

- buy commercial for faster delivery but purchase FMS for cost audit, equipment inspection, and logistics and support services; or

- purchase some components of a system FMS for lower cost and the rest, which was price competitive with FMS, commercially because of quick delivery; purchase spare parts commercially but buy munitions FMS.

These are not hypothetical examples but actual cases which reflect the complex realities of purchasing military equipment in the United States today.

#### BACKGROUND OF COMMERCIAL CEILING

The Arms Export Control Act authorizes the sale of military equipment by the U.S. Government to friendly countries and regulates the commercial export of defense articles. Controlled articles are identified in the U.S. Munitions List and published in the International Traffic in Arms Regulations (ITAR). The latter describes the requirements for obtaining approval to promote major defense equipment (MDE) and to export defense articles. The commercial export of military equipment requires an export license whereas sales by the U.S. Government, commonly known as FMS sales, do not if delivery is taken directly by the foreign government.

A 1976 amendment to the Arms Export Control Act set a \$25 million ceiling on the commercial sale of MDE except to North Atlantic Treaty Organization (NATO) countries. Japan, Australia, and New Zealand were added to the list of exempt countries the following year. Also commercial sales which implemented government-to-government coproduction agreements were exempted. In 1979, the ceiling was raised to \$35 million to compensate for the impact of inflation since 1976. MDE sales for \$35 million or more to a nonexempt countries or not related to a coproduction agreement must be on an FMS basis. The State Department maintains and updates quarterly a list of MDE. 1/ Only the cost of the item actually listed as major equipment counts against the ceiling. For example, an F-5 jet aircraft is MDE. Its engines are also included seperately on the MDE list. Thus, if spare engines were part of an order, they would count against the ceiling. Most of the other components of the aircraft are not MDE and could be sold separately in any quantity as spare parts. Similarly, support equipment or training would not count against the ceiling.

The rationale for the ceiling is that arms export restraint, foreign policy, national security interests, and general supervision of military sales are all enhanced when the purchase of significant military equipment is handled on a government-to-government basis. Some DOD and State officials believe that while commercial sales are evaluated from a foreign policy national security standpoint, they do not receive the indepth review or high level of attention focused on significant FMS cases. Other executive branch officials argued that the review differences were minor and that the controls placed over marketing since 1976 put commercial controls on a par with FMS.

During the 1976 Senate debate, a number of major commercial contracts we cited as a justification for the ceiling. The sales mentioned included a \$266 million Hawk anti-aircraft system to Saudi Arabia and a multi-million dollar sale of F-5 jet fighter planes to Brazil. Senator Case argued that both the Congress and the executive branch would be better able to supervise such sales if they were made and implemented by U.S. Government experts.

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1/To qualify as MDE an item must be considered significant combat equipment with \$50 million of U.S. Government research and development costs or \$200 million of U.S. Government procurement qualifies as MDE.

The ceiling insures congressional veto authority of all MDE arms sales of \$35 million or more since all such FMS cases are subject to section 36(b) procedures. Under section 36(b) of the Arms Export Control Act, the Congress has 30 days in which to review and veto a proposed sale. Prior to enactment of the ceiling, congressional veto authority could theoretically be avoided by using the commercial rather than the FMS channel.

#### SCOPE OF REVIEW

We reviewed:

- authorizing legislation, regulations, and several studies related to the commercial arms sales ceiling;
- documents received from the military services and the Office of Munitions Control (OMC); and
- "Quarterly Reports" of commercial arms sales over \$1 million that are sent to the Congress by OMC (this was done to determine the level of sales of MDE).

We interviewed officials within the:

- Departments of the Air Force, Army, and Navy, as well as DSAA; and
- Department of State's Bureau of Politico-Military Affairs, including OMC.

We met with:

- representatives of 14 military arms-producing companies in Washington, D.C., and various other cities (these companies were chosen because they are major exporters that have either been affected by the ceiling or have the potential to be affected because of the price of their item, the volume of their sales, or the fact that they exported items commercially);
- a former director of DSAA to obtain his perspective on the commercial arms ceiling; and
- representatives of two foreign countries to discuss their feelings about the advantages and disadvantages of FMS and commercial sales.

## CHAPTER 2

### CONTROLS OVER SALES

What are the differences in the controls over commercial and FMS sales? Some executive branch officials we interviewed told us that FMS gives the United States better control in the form of a higher level of attention and the opportunity for direct Government involvement in a sale from the very beginning. Industry, as well as other Government officials, believe that commercial and FMS controls are essentially the same and, that the controls do not distinguish between an FMS or commercial sale. In fact, with some sales no one knows at the outset if they will end up FMS or commercial.

While the review criteria for FMS and commercial sales are identical, the government obviously has more control if it negotiates the sale with a foreign country and then contracts to buy the equipment from a U.S. firm. The ceiling, however, only insures that the U.S. will be involved in the contracting process.

When the controls over marketing were strengthened in 1977, it was recognized that sales promotion by a U.S. firm might result in a request from a foreign government under the FMS program or an application for a commercial export license. Thus, the requirement that certain sales of \$35 million or more be contracted on an FMS basis does not necessarily insure a direct Government role in the making of a sale. Although the United States can prohibit a firm from marketing an item, it cannot force a foreign government to request U.S. assistance in determining the type, suitability, or quantity of equipment it needs.

This chapter will briefly summarize the differences in controls between FMS and commercial sales and other factors which tend to direct sales into the FMS channel. The discussion will center on sales of MDE.

#### COMPARISON OF FMS AND COMMERCIAL CONTROLS

The ceiling is only one of the controls over the sale of MDE. The ceiling control does not determine whether a sale will be approved--approval is granted after extensive inter-agency review based on factors, such as the President's arms transfer restraint guidelines or the political/military benefits accruing from a sale. Additionally, the Congress has veto authority over certain FMS sales.

## Arms transfer policy

The President's arms transfer restraint policy 1/ is applied across the board to requests received both by government and industry. The policy, which was announced on May 19, 1977, consists of six controls applicable to all transfers except those to NATO countries, Japan, Australia, and New Zealand. The controls state that the United States will:

- set fiscal year ceilings, adjusted for inflation, on the dollar volume of certain U.S. arms transfers.
- not be the first supplier to introduce a newly developed, advanced weapon system into a region.
- not make a commitment for sale or coproduction of a newly developed, advanced weapon system until it is operationally deployed with U.S. Forces.
- not permit development or significant modifications of advanced weapons solely for export.
- establish controls over coproduction of significant weapons, equipment, and major components.
- carefully review and may refuse recipient requests for retransfers of certain weapons.
- establish controls on weapon promotion.

FMS sales to nonexempt countries are covered by all aspects of the policy, while commercial arms sales are covered by everything but the President's annual fiscal year ceiling.

### Level of review

The same Washington officials review all FMS and commercial requests. Thus, some officials told us that there is no meaningful difference in the controls. Other officials, however, felt that there are some important differences in the degree and level of U.S. Government review that make FMS

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1/For a detailed analysis of decisionmaking under the policy, see our report: "Opportunities to Improve Decisionmaking and Oversight of Arms Sales" (ID-79-22, May 21, 1979).

control superior. For example, these officials pointed out that there is regular reporting on those FMS inquiries or requests made directly to U.S. Government officials; in fact, the U.S. Government may be involved in direct negotiations over what the country wants, quantity, and the terms. On a commercial sale, they claim that the U.S. Government may be in the dark from the time of promotion approval until the company applies for an export license.

The level of review for FMS and commercial sales does differ slightly, as follows:

- The President reviews sales notified to the Congress under section 36 (b) procedures of the Arms Export Control Act.
- The Under Secretary for Security Assistance is generally the highest level of review on a commercial sale.
- The Congress has veto authority over all FMS sales of MDF above \$7 million, but not over commercial sales of MDE between \$7 and \$35 million.
- The Embassy and in-country American military personnel are not required to comment on or analyze proposed commercial sales. They might not even be aware of the sale. Many companies told us, however, that they do visit and inform the Embassy of their activities.

Industry believes that if the level of review for commercial sales is inappropriate, then the executive branch should take steps to correct it.

#### Promotion approval

When the commercial arms sales ceiling was enacted, there was general concern about the effectiveness of controls over sales through both Government and commercial channels. Several steps have been taken since 1976 to strengthen controls at what was considered a weak point--marketing. New restraint guidelines were issued to Embassy and security assistance personnel which emphasized that they were not to encourage arms sales and requiring them to seek policy level approval from State before taking any action which might do so. Similarly, industry was required to obtain State Department approval before initiating major sales promotions. Specifically, in September 1977, ITAR was amended to require State approval

before a proposal or presentation is made which could form the basis for a decision to purchase commercially or FMS, significant combat equipment valued at \$7 million or more. Prior approval can be obtained through:

- Advisory opinions which request State's advice about whether a sale of certain equipment to a particular country would be approved. State's responses are tentative and subject to change, but the companies regard favorable opinions as strong indications that an export license will be granted.
- Technical data licenses which grant approval to export or give technical data to the foreign country.
- Temporary export licenses which grant approval to export on item for demonstration or exhibition at a trade show.

Requests to promote major equipment are reviewed by CMC, other State Department offices, DOD, and the Arms Control and Disarmament Agency (ACDA). They can be denied for political or arms control reasons or because the transfer conflicts with the President's arms restraint policy. Several opinions about the effectiveness of these reviews as a control mechanism, arose during our review. One State Department official said that this review is only a screening to deny the obviously objectionable requests. He claimed that the vagueness of the information supplied by industry in such areas as country interest, quantity, and cost are inhibiting factors to a thorough review.

The Director of CMC and a former Director of DSAA said that prior approval is an effective control. The latter official said there was no front-end control over commercial sales in 1976. However, in his opinion, the ITAR amendment requiring prior approval gives the United States the same forward knowledge about commercial sales that they have about FMS sales.

Company officials emphasized that promotion approval is an absolute control. They said that denial of the promotion request can stop the process before the country becomes interested in the specific equipment. It saves the company the time and money of promoting an item that they would not be able to export. One company has developed its own system of rating countries in order to guide its marketing efforts. It rates countries on a scale of 1 to 5--the lower the rating, the higher the probability of obtaining an export license. We

were told the company does not want to waste time marketing an item for which it will not be able to obtain an export license. Company officials claim that a "control" decision should be possible on the promotion request because the defense article is known and a decision should be based on the equipment and the country involved. If additional information is needed, company officials indicated a willingness to supply it. They claim, however, that the information currently provided is clear and detailed.

Both company and executive branch officials emphasized that the time to control a sale is at its inception, i.e., before a country becomes interested in buying a specific weapon. Company officials said that the ITAR amendment, which strengthens controls over all arms sales, recognizes that industry promotes sales. One company official told us that they will promote FMS if they cannot obtain a commercial sale.

#### CONTROLS WHICH LIMIT OR DIRECT SALES INTO FMS CHANNELS

Some equipment on the MDE list is not releasable to particular countries on either an FMS or commercial basis because the technology is considered too sophisticated or because of its security classification. At the same time, sales valued at less than \$35 million (which the ceiling permits to be made on a commercial basis) may be directed into the FMS channel because the item contains certain government-furnished equipment or because of a decision by State or DSAA that the sale should be handled on a government-to-government basis.

#### Sophistication of technology

The sophistication of technology may prevent a sale of equipment to either one or most countries. Thus, some items are not even available to all U.S. NATO allies. For example, one military service told us that they had a U.S. and an export version of a certain MDE item. Only a few close allies have been permitted to buy the U.S. version. The following are examples of items not releasable to nonexempt countries due to sophistication of technology:

- cannon-launched guided projectiles,
- AIM-9L missile (Sidewinder) (a Presidential exception was made for Israel),
- Standard Arm missile,
- Tomahawk missile,

- MK-48 torpedo,
- XM-1 tank, and
- joint tactical information distribution system.

### Classification

MDE becomes classified if it contains a classified component. Even if the equipment is not classified, the technical or performance data may be. Each country is cleared to receive equipment or information up to a certain level of classification. Thus, if an item is "Secret" but a country is only cleared for "Confidential" the equipment would not be releasable to that country unless an exception is approved. The following items each contain classified components:

- AGM-45 missile (Shrike),
- Cruise missile,
- HARM missile,
- AIM-9L missile (Sidewinder),
- AIM-7 missile (Sparrow),
- ALQ 119 (electronic countermeasures device carried by an aircraft), and
- Aircraft may contain classified components such as the electronic warfare and Identification Friend or Foe systems.

We were told that classified components are usually sold FMS. However, commercial sales to approved countries may be possible as long as the classified information or item is transferred from a U.S. Government official to a foreign government official.

### Government-furnished equipment (GFE)

When the United States buys a piece of military equipment, it may supply some of the components to the manufacturer. These components are referred to as GFE and are a result of either a U.S. Government purchase or production. For example, when the U.S. Government purchases armored personnel carriers (M-113s) from FMC Corporation, it supplies

FMC with the following items: engines, transmissions, radios, and guns. Similarly, on an FMS sale, the Government will supply the components to a manufacturer for equipment being sold to foreign countries.

GFE can only be purchased through the FMS channel, but procedurally, the manufacturer can act as the agent for the foreign country and sign all necessary FMS forms. However, since most GFE is simply equipment purchased commercially by the U.S. Government (equipment manufactured to Government specifications), satisfactory commercial substitutes are often readily available and, in fact, both may come from the same production line. For example, the only difference between an item purchased GFE and the same item purchased commercially may be the paint color or a label with the U.S. Government serial number. Although many of these items are also available commercially, the bulk-buys by the Government create lower prices than are perhaps available on smaller commercial purchases. As a result, it becomes attractive to acquire the items GFE which requires an FMS case. Sometimes the U.S. Government may have a production line tied up so the item can only be acquired GFE through production diversion or out-of-inventory sales.

Some GFE has no commercial sources because it is manufactured or assembled in a U.S. Government arsenal. The following are examples of these items, the

- propellant for the AIM-9P3 missile,
- fuel stick used to start the electronic power unit for the guidance and control section of the AIM-7E sparrow missile,
- canopy and seat ejection cartridge for aircraft, and
- gun barrel for the A-37 aircraft gun.

Some GFF is highly classified and is only sold on an FMS basis. Certain radar and cryptographic equipment fall into this category.

#### Decisions by State and DSAA

The State Department and DSAA are influential in determining whether a sale will be FMS or commercial. Their impact and recommendations, though, will vary according to the situation. The following examples illustrate FMS recommendations:

--State recently told FMC Corporation that a sale of M-113 armored personnel carriers to a Middle Eastern nation would be better if FMS.

--The Swiss, who are known to investigate wide ranges of possible buying methods (total commercial, total FMS, mixed purchases), were told by DSAA that a purchase of the Blackhawk Helicopter would have to be through FMS channels.

--Midway through negotiations between Korea and Bell Helicopter Textron, the incountry American military personnel and Embassy wanted the sale to go FMS and actually began competing for it-- the sale went FMS.

DOD is not always successful in channelling a sale into FMS. For example, Hughes Helicopter was negotiating with Korea for a coproduction agreement for the 500 MD helicopter. The U.S. military incountry argued that Korea should buy the helicopter used by the U.S. Army. The sale eventually went commercial except for the missiles.

In some cases, State and DSAA have recommended commercial sales.

--State encouraged Turkey to purchase F-4s commercially in 1976 because of the embargo. Turkey wanted to use FMS and eventually did so.

--DSAA recommended a commercial transaction on a sale of the I-HAWK missile to Saudi Arabia although the Saudi King wanted to use FMS.

--DSAA told Lockheed to sell three C-130s to Oman commercially. Lockheed said they could not because of the ceiling.

#### CONCLUSION

The same review criteria are applied by the same Government offices to both FMS and commercial sales. Significant sales should and probably do get a more rigorous review. Some officials argued that FMS cases get greater scrutiny and a higher level of attention. We believe this reflects the fact that more significant sales are made on an FMS rather

than a commercial basis. Factors such as government-furnished equipment, classification, and customer/Government preference tend to push significant sales into the FMS channel.

In the majority of cases, these factors, not the ceiling, determine which purchase channel will be utilized. The requirement that firms seek approval before promoting significant defense equipment should provide the Government with sufficient opportunity to either prevent a sale or to stipulate that the sale be negotiated and implemented on an FMS basis.

## CHAPTER 3

### IMPACT OF THE CEILING

The commercial arms sales ceiling has had a limited impact on whether a major item is sold on an FMS or commercial basis. We examined a number of major commercial sales made both before and after enactment of the ceiling and found either that the United States endorsed the commercial channel or that significant portions of these commercial sales contained FMS contracts. Most Government officials believe that significant sales should be contracted through FMS. However, some believe that the ceiling is not necessary to prevent use of the commercial channel. While industry wants the flexibility to use the commercial channel, only a few companies have actually been affected by the ceiling. Both foreign governments contacted preferred FMS for major purchases. This preference was evidenced by our examination of section 36 (b) notifications. Many exempt countries continue to buy major items on an FMS basis while nonexempt countries use the FMS channel even when the sale falls below the ceiling.

#### SALES PATTERNS SHOW LIMITED IMPACT

An examination of sales patterns demonstrates that the ceiling has had a limited impact on whether a major item is purchased through FMS or commercial channels.

##### Commercial exports, low volume

Commercial exports have always been substantially lower than FMS deliveries. Thus, the average volume of commercial and FMS exports for 1970-75 was \$460 million and \$2 billion, respectively. While commercial exports remained stable during the early 1970s, FMS deliveries climbed dramatically from \$1.46 billion in 1972 to \$3.48 billion in 1975. <sup>1/</sup>

In fiscal year 1976, a better system was introduced to keep track of commercial exports. The State Department attributes the apparent increase in commercial exports that year to better recordkeeping. Commercial exports for earlier years were understated. Nevertheless, the 1 to 4 (\$1.4 to \$5.9 billion) ratio of commercial to FMS deliveries for fiscal year 1976 and the transition quarter was the same as the ratio for

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<sup>1/</sup>During this same time frame, FMS orders went from about \$3 billion to just over \$10.5 billion.

fiscal years 1970-75. More recent statistics show that in fiscal year 1978, commercial exports were only \$1.48 billion compared to FMS deliveries of \$7.7 billion.

Few sales over \$25 million

Commercial orders and exports of MDE seldom went over \$25 million. State Department statistics show that in fiscal year 1975 there were no exports over \$25 million and in fiscal year 1976, only six orders were valued at more than \$25 million, as shown below.

<u>Commodity</u>	<u>Country</u>	<u>Quantity</u>	<u>Value</u> (millions)
F-5 aircraft	Brazil	16	a/ \$26
C-130 aircraft	Nigeria	4	\$26
C-130 aircraft	Greece	4	\$25
C-130 aircraft	Malaysia	6	\$37
CH-47 helicopters	Iran	10	\$31
UH-1H helicopters	Israel	62	\$50

a/State Department statistics reflect only a portion of the total order which was placed in 1973.

With the exception of the F-5 sale (which is discussed in some detail on p. 19), all commercial orders in fiscal year 1976 of \$25 million or more were for transport aircraft.

Few MDE items sold commercially

Relatively few items which qualify as MDE have traditionally been sold in the commercial channel. Thus, in fiscal year 1976, the last year in which commercial sales were not subject to the ceiling, orders for MDE valued at more than \$1 million consisted of

- C-130 aircraft,
- SH-3D helicopters,
- M-113 armored personnel carriers,
- various jet and turbine engines,
- AH-1J helicopters,
- UH-1H helicopters,
- M-16 rifles,

- AIM-7E sparrow missile, 1/
- F-5 aircraft, and
- CH-47 helicopters.

Discrimination against expensive, low-volume items

The ceiling discriminates against a few items which are expensive, typically sold in lots of from 2 to 10, and traditionally sold in the commercial channel. For example, the Lockheed C-130 now sells for \$10 to \$11 million and is frequently purchased two, three, four, or six at a time. Between 1968 and 1976, 82 percent of all C-130s exported were sold on a commercial basis. Helicopters also fall in this category. Industry believes that the ceiling also discriminates against customers who must use the FMS channel, where they may experience later deliveries at higher prices.

Affects quantities sold

The ceiling does not prevent the sale of MPE through commercial channels. Rather, it permits the commercial sale of larger quantities of some equipment and smaller quantities of others. Manufacturers with a low cost are either unaffected or not as seriously affected. For example in 1979, the ceiling allowed a foreign country to purchase about:

Ceiling at \$35 million

- |   |                                    |
|---|------------------------------------|
| --5 million 20mm cartridges,<br>or      | --140,000 M-16 rifles,<br>or       |
| --350 armored personnel carriers,<br>or | --35 UH-1H utility helicopters, or |
| --6 CH-47 helicopters,<br>or            | --3 C-130 transport aircraft.      |

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1/Turkish purchase of the Sparrow missile was switched from the FMS channel to a commercial sale because of an FMS embargo on Turkey. Since some of the missile components are manufactured in a U.S. arsenal and must be sold FMS, a pure commercial sale was not possible. When the embargo was lifted, the sale was consummated on an FMS basis.

### Some items normally sold FMS

For a variety of reasons, some types of MDE, such as sophisticated aircraft, missiles, artillery, and tanks, are normally sold through FMS channels. Many of these reasons--customer, U.S. Government, or company preference; cost; GFE; and classification--are discussed in other sections of this report.

### MDE excludes some equipment

The ceiling is based on a definition of MDE which excludes equipment that we were told was significant. Qualifying as MDE requires, in part, \$50 million of U.S. research and development funds or \$200 million of U.S. procurement. Thus, an armored car manufactured by Cadillac Gage but developed with company funds can be sold commercially in any quantity. Examples of other equipment not meeting the MDE definition include the Armored Infantry Fighting Vehicle and the TPS-43E air defense radar. The State Department commented that even if the Armored Infantry Fighting Vehicle did not meet the MDE dollar criteria, they treat it as if it were major defense equipment.

### MANY COMMERCIAL SALES OF MDE HAVE FMS COMPONENTS

We examined a number of large commercial sales contracted both before and after the ceiling was enacted to determine why the commercial channel was utilized. A significant portion of each "commercial" sale had actually been transacted through FMS channels. We found that because of cost, nature and quantity of GFE, customer preference, and ability of the military service to manage a particular sale, MDE is sometimes sold on a mixed commercial-FMS basis. Two of the "nominally" commercial sales we reviewed were cited in the 1976 Senate floor debate as the type of major commercial contracts which should be subject to tighter executive branch supervision by requiring them to be handled by the U.S. Government's FMS program experts.

### F-5 sale to Brazil, 1973

Brazil had expressed interest in supersonic aircraft, including the F-5 beginning in the mid 1960s. However, it was not until President Nixon lifted the restriction on the introduction into several Latin American countries of supersonic aircraft that the F-5 sale became possible. We were told by U.S. officials that in 1973, the executive branch

encouraged Northrop's sales efforts. A high-level DOD team was sent to negotiate with the Brazilians. The U.S. officials insisted that Brazil use FMS credit even though Brazil preferred a cash sale. At the same time, Northrop officials negotiated a commercial contract with Brazil on the airframe portion of the program.

Northrop's contract with Brazil totaled \$72.3 million, and included 6 F-5B and 36 F-5F jet aircraft, less engines and other GFE. Northrop officials told us that the Brazilians wanted a commercial contract to gain procurement and management experience. Thirty Brazilian Air Force procurement personnel worked for more than two years at the company's Hawthorne, California, plant. Brazil signed more than \$36 million worth of FMS cases with the U.S. Government for engines, initial spare parts, and technical data.

I-Hawk Missile System to  
Saudi Arabia, 1974 and 1976

In 1974, Saudi Arabia decided to update 12 Hawk battalions purchased commercially several years earlier. The updating involved modification of ground equipment and replacement of the missiles with the new I-HAWK missile. The cost was \$266 million. Then in July 1976, just prior to the effective date of the commercial arms sales ceiling, the Saudis signed a \$1 billion direct contract for six additional I-HAWK batteries.

In updating the HAWK system in 1974, Saudi Arabia asked for a mixed commercial/FMS sale. Raytheon, the manufacturer, believed it should be all FMS or all commercial. Both DSAA and the Army encouraged Saudi Arabia to buy directly from the company rather than switching to FMS. DOD argued that the Saudi's experience with Raytheon had been good and that DOD would look over the contract to ensure that it was fair. The scope of the project, which included construction and training, was one factor behind the DOD recommendation. Managing such a case could have strained DOD manpower, and would have resulted in an unacceptably large U.S. military presence in Saudi Arabia.

In both the 1974 and 1976 sales, the warhead and rocket motor portion of the I-HAWK missile was transferred under an FMS case. The warhead is assembled in a U.S. Government arsenal and can only be sold through FMS. The Saudi Government authorized Raytheon act as its agent on the FMS case. Although the value of these components was only \$6 million, the missiles are useless without them. On an FMS or U.S. buy of I-HAWK missiles, all the components are shipped to the

Government-owned/operated Fed River Arsenal in Texas for assembly by Government employees. Since Raytheon does not own facilities to final assemble the missile, on a commercial sale, it rents space at the arsenal and uses its own employees. Rentals are approved by the Army to the extent excess capacity is available.

#### F-4 sale to Greece, 1977

In the early 1970s Greece purchased 36 F-4 aircraft on an FMS basis from McDonnell-Douglas. An additional 26 aircraft were purchased commercially in 1977. The \$158 million contract with the manufacturer, however, did not include engines and M61-A1 guns which were ordered FMS. The FMS portion of the sale was \$32.6 million. The sale was mixed, even though Greece is a member of NATO and, therefore, exempt from the ceiling.

McDonnell-Douglas told us that several factors influenced Greece's decision to go mixed commercial/FMS on the second buy:

- Greece, because of the earlier buy, had confidence in the manufacturer and the product. McDonnell-Douglas felt Greece would never have made its initial purchase through the commercial channel.
- The delivery time was shorter under a direct contract.
- Greece believed it had saved money.

McDonnell-Douglas and the Air Force submitted identical price quotes for the airframe. However, a direct price quote from General Electric for the engines was higher than the FMS cost. By buying the airframe direct, Greece avoided a 3 percent FMS administrative surcharge; similarly Greece saved money by contracting for the engines FMS. McDonnell-Douglas prepared a letter of intent which gave Greece the option of an FMS or commercial contract.

#### Hughes 500 MD TOW Helicopter to Korea, 1976

In 1976, Korea signed a \$60 million commercial contract with Hughes Helicopter to co-assemble 100 Hughes 500 MD helicopters. Twenty-five of the helicopters were equipped with the TOW anti-tank missile system. The helicopter is not MDF but the missile and launcher are. The missiles are produced by a different company--Hughes Aircraft. Because some of the missile components are manufactured in a U.S. arsenal and,

therefore, must be sold FMS, Korea ordered them from the U.S. Government. Korea subsequently purchased 48 additional Hughes helicopters directly from the manufacturer.

The Hughes helicopter is based on the OH-6 Scout developed for the U.S. Army. At its own expense Hughes modified the aircraft and adapted it to accept the TOW anti-tank missile system. The 500 MF TOW is not in the U.S. inventory. Hughes told us that U.S. military advisors in Korea were opposed to the sale and wanted Korea to purchase the U.S. Army Cobra helicopter manufactured by Bell.

Another country which purchased 500 MF helicopters confirmed that it is difficult to persuade the services to make an FMS purchase of a system not in their own inventory. In order to overcome the advice given by the U.S. military, Hughes had to convince Korea that it would offer better support than the U.S. Government did under FMS. An additional factor that apparently influenced the Korean decision was the willingness of Hughes to permit co-assembly, if approved by the U.S. Government.

#### EXECUTIVE BRANCH VIEWS

Most of the executive branch officials we interviewed believe that the U.S. Government should be directly involved in significant sales of MFE. There is a wide range of opinions, however, as to whether the ceiling is necessary to keep significant sales in the FMS channel.

The Director of DSAA and the Chief of the Air Force FMS program both believe that without the ceiling, commercial sales of MFE would increase. The ceiling acts as a deterrent, we were told, to keep nonexempt countries in the FMS channel.

One DSAA official emphasized that aside from the ceiling, there was no policy barrier to the commercial sale of MFE. Only items manufactured in a U.S. arsenal must be sold FMS. With varying degrees of difficulty, arrangements could be made to sell most other equipment on a commercial basis. The same official added that many countries do not have the expertise to negotiate a complex commercial contract and thus prefer to have the U.S. Government handle it through the FMS program.

Both State and DOI officials doubted that industry could show any documentary support for sales lost because of the ceiling. For example, the Director of OMC said that the ceiling has not really been a problem for anyone except Lockheed.

The DOD legal advisor, who helped draft the 1976 legislation requiring the ceiling, told us that most countries, even those with purchasing missions in the U.S., would not buy anything significant commercially even if they could do so. As the former Director of DSAA pointed out, none of our close Western allies, all of whom are exempt from the ceiling have gone overwhelmingly commercial. They do so only when they think it makes sense. The Director of the U.S. Navy Security Assistance program agreed that there would be no significant increase in commercial sales without the ceiling. He said, because of GFE, most sales could not be totally commercial anyway, and that it sometimes makes a commercial sale too complicated.

The head of the Army FMS program asserted that most countries want the services and protection offered by DOD procurement. Another official told us that countries chose the commercial channel only for standard items, such as the C-130 or for spare parts. He asserted that the rationale behind the ceiling was the belief of the Congress that sales needed more control and that FMS was the answer. DOD, he continued, saw the ceiling as a way of controlling U.S. firms from overcommitting themselves on foreign sales to the detriment of U.S. procurement. By forcing large sales into the FMS channel DOD could "dovetail" U.S. and foreign requirements. He believes that there are administrative remedies to address the problem of overcommitment and that the ceiling is not necessary to handle the problem.

#### INDUSTRY OPINIONS

Industry believes that nations desiring to purchase defense equipment from the United States should be permitted to do so on whatever the most sensible contractual footing for the particular transaction or program, consistent with adequate control by the appropriate U.S. Government agencies. They feel that the option to contract on an FMS, commercial, or mixed FMS/commercial basis should be available.

We found that the extent to which a company's product had been sold commercially in the past is a major factor affecting how a company feels about the commercial arms ceiling; other important factors include whether

- the price and quantity in which it is typically purchased result in sales below, near, or far in excess of the ceiling;
- the usual purchaser of the product is an exempt or nonexempt country;

- the rate of production is high or low;
- there is a backlog of orders;
- there is stiff competition from other manufacturers;
- the item is currently being procured by the U.S. Government; and
- the item is in the U.S. inventory;

Given the number of variables, the range of opinions on the ceiling's impact is not surprising.

We asked all 14 companies, manufacturers of commercially sold MDE, if the ceiling had resulted in

- lost sales,
- a reduction in quantity to stay within the ceiling,
- deferring a portion of a planned purchase, or
- any sales forced into the FMS channel, when the customer preferred a commercial contract.

Only 4 companies out of 14 believe that the ceiling has no direct impact on their business.

Hughes Aircraft manufactures missiles such as TOW, Maverick and Phoenix and electronic systems and subsystems. The company believes that lethal items such as missiles are usually best sold through FMS channels. Several major components of the TOW missile are manufactured in a U.S. Government arsenal and must be sold FMS anyway. However, they feel electronics systems are often better handled commercially, particularly when they must be tailored to the particular requirements of the customer.

McDonnell-Douglas manufactures jet aircraft such as the F-4 and the F-15. In general, the company prefers FMS transactions. The typical sale of advanced jet fighters is substantially in excess of \$25 million. The company believes that an overwhelming majority of their customers--mostly exempt countries--prefer FMS, especially if they are purchasing the item for the first time. Of the 1,300 F-4s sold to nine countries, only three were commercial sales and only one

was to a nonexempt country. In order to take earlier delivery, Iran bought commercially 4 reconnaissance versions of the F-4 in 1970. However, Iran has purchased more than 230 F-4s through FMS channels.

Colt manufactures the M-16 rifle. The largest single transaction, an order for 30,000 rifles, was well below the ceiling. Thus, although the Army has told Colt that they prefer the M-16 to be sold commercially, the ceiling is not an impediment.

Avco-Lycoming which manufactures engines used in helicopters and tanks normally does not sell directly overseas. Rather, they sell to manufacturers such as Lockheed, Boeing-Vertol and Bell Helicopter. Its only direct sales are replacement or spare engines for aircraft purchased from these U.S. firms. However, sales to one country over a period of 5 years were approximately \$40 million.

The 10 other manufacturers asserted that the ceiling had complicated their sales efforts to varying degrees.

Only a few companies claimed that they had "lost" sales because of the ceiling. Boeing-Vertol told us that it felt it had lost a particular sale because of the timing constraint of FMS. FMS would have delayed procurement to a point after the fiscal period in which the funds were available and consequently the FMS case was canceled. Because of the number of aircraft involved the country had to forego a commercial transaction. Lockheed told us that a number of countries had indicated a requirement for more than the two aircraft which can be purchased commercially and that these may be lost sales. One country which has a requirement for six C-130s bought only two in order to stay under the ceiling. It negotiated an option for a third in anticipation of the ceiling being raised to \$35 million.

Many companies told us that customers had either reduced the quantity to be purchased or deferred a portion of a planned purchase in order to stay under the ceiling. For example, FMC sold one country 235 rather than 298 M-113 armored personnel carriers because that country wanted a direct commercial contract. A different country bought 175 M-113s in 1978 and is now negotiating to buy 175 more. Sikorsky told us that one customer, who prefers the commercial channel, plans to buy two CH-53 helicopters at a time instead of the six it wants in order to avoid going FMS.

Aerospace companies which prior to the ceiling had concluded a number of mixed commercial/FMS sales, have been precluded from this option with nonexempt countries because of the ceiling. Mixed sales, in which the engines are procured FMS, are cheaper than a totally commercial transaction. Because the U.S. Government buys the engines in quantity it gets a lower price. For example, Northrop has told a number of countries who asked for a totally commercial sale that in addition to being prohibited by the ceiling it was also cost prohibitive. For this reason, in 1975-76 Northrop recommended a mixed sale to a country which wanted a commercial transaction because of unsatisfactory FMS experiences. However, when the \$25 million ceiling went into effect in late 1976, Northrop had to persuade the country to make the purchase on an FMS basis.

Rockwell produces several MPE items, including the OV-10 armed reconnaissance aircraft, T-2 jet trainer, SINCGARS (V) radio set and the CBU-15 guided bomb. Although it cannot be said that sales were lost as a direct result of the ceiling, company marketing efforts were greatly complicated. Rockwell was not able to consummate prospective sales for OV-10 aircraft in three countries because of an inability to meet customer desires relating to quantity and price under the ceiling. One country refused to buy aircraft under FMS procedures.

Hughes Helicopter manufactures a small helicopter that can be equipped either with the TOW anti-tank missile system or an anti-submarine warfare capability. If a customer is interested in a quantity which brings the sale close to the ceiling, Hughes will encourage the country to reduce the quantity to stay under the ceiling. One foreign country did reduce its requirements in order to contract on a commercial basis. The TOW missile, itself, however must be sold FMS (see p. 21).

The most frequently repeated complaint about the ceiling and FMS is time. We found a general consensus within Government and industry that FMS takes 9 to 12 months longer than commercial sales. For some companies this additional time can be critical, especially if orders and production are declining. It can put a financial drain on a company in procuring long lead-time materials, resulting in a cash flow problem.

Between 1975 and 1979, Lockheed's C-130 orders backlog declined from 75 to 24 and the production rate was cut in half. Following enactment of the ceiling in 1976, Lockheed experienced a long "dry spell" before the now prohibited large commercial sales could be contracted through the more

time-consuming FMS process. Lockheed believes that the longer negotiation time for FMS contracts has contributed to their declining backlog. In turn, Lockheed's financial exposure on the procurement of long lead-time materials or components has increased. Earlier payments resulting from the speedier negotiation of commercial sales contracts would improve Lockheed's cash flow.

Lockheed's circumstances may be peculiar to that company, but other companies confirmed that commercial transactions result in a more favorable cash flow because of earlier contractual coverage. Although the U.S. Government requires payments from the foreign government shortly after the FMS case is signed, the company receives no payments until a separate contract is negotiated between it and the U.S. Government. Then the contractor receives progress payments for work completed. In contrast, contractors usually require more favorable cash prepayments on commercial transactions. FMC corporation told us that it normally requires a 30-percent cash down payment when the contract is signed and an additional 30 percent 6 months later.

McDonnell-Douglas, a company which generally prefers the FMS channel, provided the following example. Saudi Arabia signed an FMS case for the purchase of 60 F-15s on July 13, 1978. In order to meet the delivery schedule McDonnell-Douglas began placing long-lead-time purchase orders for forgings and castings soon thereafter. Although it had already incurred costs, McDonnell-Douglas received no payments from the United States until after February 23, 1979, when a letter contract authorizing long-lead procurements was signed. As of August 1979 a definitive contract with the United States had still not been finalized. McDonnell-Douglas told us that they became nervous about cancellation of the sale when Saudi Arabian officials publicly discussed the purchase of Iranian F-14s. Until a definitive contract is signed, the United States is under no obligation to accept delivery of the aircraft. McDonnell-Douglas officials told us that time is the biggest drawback to FMS and that this one issue could "drive" them into the commercial channel.

#### HOW FOREIGN GOVERNMENTS FEEL

We met with representatives of the U.S.-based purchasing missions of two countries--one exempt and the other non-exempt. Both countries are close U.S. allies.

### The exempt country

The Director of their purchasing mission told us that they prefer the FMS channel for MDE in part because they know that the U.S. Government will negotiate the best possible price for a foreign customer. When the country deals directly with a U.S. firm they are given a price and told to take it or leave it. This country made a recent large purchase of helicopters in the commercial channel only because an FMS contract could not be negotiated quickly enough. Because the country was exempt, it was able to go direct. However, the Director told us that they would have preferred to buy FMS and they believe that they paid a higher price than the United States pays for the same item. It did purchase an FMS cost audit and bought into the U.S. Cooperative Logistics Support System for spare parts.

### The nonexempt country

Purchasing mission officials told us that the ceiling had not had much impact on them. However, they would appreciate having more flexibility in utilizing the commercial channel. Sixty percent of their orders are for less than \$5,000 and very few cases are above \$25 million. We were told that even if it were possible they would not consider on a first buy, the commercial purchase of a new jet fighter which the U.S. Air Force was just taking into inventory. First, it would be a very complicated procurement and thus from the standpoint of efficiency Air Force management of the purchase would be more sensible. Second, in any sophisticated new product, engineering changes and improvements are likely and FMS offers an option which automatically plugs the foreign purchaser into such changes. Thus, if the aircraft developed "wing cracks", the U.S. Air Force would move quickly to resolve the problem. Foreign purchasers would be notified and modifications could also be made in their planes.

The officials from the purchasing mission told us that on standard items which have been in the U.S. inventory for a long time and which the country has itself purchased previously, there might be some price or delivery advantage to a commercial sale. For example, they would consider purchasing armored personnel carriers commercially since it is a known commodity which meets the above criteria. As to cost, these officials feel that commercial was generally cheaper because it avoided the FMS administrative surcharge.

## EFFECT OF RAISING CEILING TO \$35 MILLION

In 1979, the ceiling was raised from \$25 million to \$35 million. We asked the 14 companies we visited whether the increase in the ceiling would alleviate any of the problems they had experienced with a \$25 million ceiling. An earlier section of this chapter deals with industry's views on the ceiling impact.

The 10 companies who believed that the ceiling had unnecessarily complicated or impeded their marketing efforts, said that at best \$35 million was only a temporary relief. A few companies felt it put them back where they were in 1976, while some believed that it did not even produce real parity in 1976 dollars with a \$25 million ceiling. Although some of these companies favored elimination of the ceiling entirely, most told us that a ceiling set at \$50 to \$75 million would not be hard to live with. It would cover improvements over the next several years and give them some flexibility in negotiating sales contracts. In short, these companies felt that the quantities in which nonexempt countries normally bought their product could be accommodated under a ceiling set at \$50 or \$75 million. However, several aerospace companies pointed out that due to unit cost and typical quantity purchased, a ceiling set at \$100 million or even higher would be more realistic.

Lockheed said that a \$35 million ceiling would allow them to sell three C-130s but that in time inflation will force them to revert to two aircraft per contract.

Sikorsky said they would like to see the ceiling set at \$50 million which would permit sales to nonexempt countries in 5 to 10 aircraft lots if the country prefers the commercial channel. They did not believe that increasing the ceiling would increase commercial sales very much but would improve the companies flexibility in negotiating marginal sales.

FMC Corporation told us that any ceiling higher than \$25 million is an improvement. FMC would favor a ceiling of at least \$50 million. Some countries want to purchase armored personnel carriers, two battalions at a time. The \$25 million ceiling allows the purchase of only one battalion.

Finally Boeing-Vertol finds a \$35 million ceiling now more restrictive than the original \$25 million ceiling because of the higher rate of inflation on CH-47s. Increasing the ceiling above \$35 million would give the company and the customer greater flexibility in negotiating a sale.

We also analyzed the section 36 (b) notifications to determine the impact of increasing the ceiling to \$35 million, to \$50 million, or to \$75 million.

First, it is revealing to note that nonexempt countries often choose not to buy commercially even though the value of the sale is less than \$25 million. In fiscal year 1978, the Congress was notified of six sales where the

- value of the sale was less than \$25 million;
- purchaser was a nonexempt country; and
- equipment had previously been sold in the commercial channel.

The equipment included M-113 armored personnel carriers, F-5E jet aircraft, and combat recovery vehicles.

In fiscal year 1978, 108 notifications were sent to the Congress. Sixteen had a value of between \$25 and \$75 million. <sup>1/</sup> Many of the items are traditionally sold, can only be sold, or were sold to both exempt and nonexempt countries who preferred FMS. Two of the 16 section 36 (b) notifications were between \$25 and \$35 million. Both purchasers were nonexempt countries. The Harpoon missile and the MK-46 torpedo are munitions which are not normally sold commercially. It is doubtful that these sales could have been switched to the commercial channel had the ceiling been higher. Twelve of the 16 section 36 (b) cases were between \$35 and \$50 million. Only four were for items which have previously been sold commercially; F-5 aircraft, M-548 cargo carriers, and CH-47 helicopters. Two other sales were to exempt countries but the items probably had to be sold FMS anyway. The MK-48 torpedo is the Navy's first-line torpedo and has been released to only a few exempt countries. It would probably only be sold FMS. The TOW missile contains components manufactured in an Army arsenal which can only be sold FMS. Of the remaining six notifications, the M-60 tank, the MK-13 missile launcher, and the dragon missile have not been sold commercially.

Only two of the 16 fiscal year 1978 section 36 (b) cases were between \$50 and \$75 million. An exempt country, which prefers FMS bought the MK-48 torpedo, described above. A nonexempt country purchased the AH-1S helicopter gunship. The

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<sup>1/</sup>The value of these notifications frequently included spare parts or support equipment which are not counted against the commercial arms sales ceiling.

helicopter itself could probably be purchased commercially but the munitions it carries, the TOW missile, must be transferred through FMS channels.

An analysis of section 36 (b) notifications for fiscal years 1975 through 1977 showed similar results.

## CHAPTER 4

### ALTERNATIVES TO A COMMERCIAL SALES CEILING

The commercial arms sales ceiling incorporates several control concepts. As a result, alternatives which satisfy the interests of both the Congress and the executive branch are difficult to identify. The various control concepts of the ceiling

- give the Congress a veto over what would have been direct commercial sales;
- give the executive branch the opportunity to get involved early in a sale so that it can influence the type and quantity of equipment requested;
- permit the military departments to control the impact of foreign sales on U.S. defense readiness and to recommend a support and spares package to ensure the military effectiveness of the equipment; and
- ensure that significant sales are on a government-to-government basis (the executive branch feels this is important because of the potential foreign policy and military impact).

During our review, we identified and discussed with government and industry officials several alternatives to the present ceiling on commercial arms sales. They are not mutually exclusive and several could be combined. The alternatives are examined in the following sections.

#### ELIMINATE THE CEILING

The ceiling could be eliminated if the Congress believes the controls described in chapter 2 are adequate. However, unless certain sales were subjected to section 36 (b) procedures, the Congress would lose its veto authority over a few types of high-dollar value equipment traditionally sold commercially but now forced into the FMS channel. Although this approach might result in a slight increase in commercial exports of transport aircraft, helicopters, and armored personnel carriers, the shift of tank, missile, and jet aircraft sales to the commercial channel is unlikely. These items would continue to be purchased on a government-to-government (FMS) basis. Several State and DOD officials told us, unofficially, that elimination of the ceiling would have little impact on the composition or volume of commercial sales.

Others believed that eliminating the ceiling would require a re-examination of all controls over commercial sales. They felt that commercial sales do not receive the same degree of scrutiny or high-level of attention as FMS sales. The same offices, however, review the requests for commercial as well as FMS sales.

Without the ceiling, the importance of the prior approval of promotion increases. Denial of promotion approval could prevent a country from becoming interested in an item by stopping the marketing process designed to nurture that interest. Alternatively, a condition of promotion approval could be that any resulting sale be through FMS channels. Even without a ceiling, U.S. needs and priorities for equipment can be met and protected through existing administrative procedures.

SUBJECT SIGNIFICANT  
SALES TO SECTION 36 (b) PROCEDURES

The Congress could eliminate the ceiling but still ensure its veto power over significant commercial sales by subjecting those over \$25 or \$35 million to section 36 (b) procedures of the Arms Export Control Act. Currently, the legislative veto contained in this section applies only to FMS sales. A precedent for applying the legislative veto to commercial sales exists in the area of coproduction agreements. In 1977, the Congress exempted from the ceiling all commercial exports in support of a coproduction agreement as long as the agreement is covered by a Memorandum of Understanding between the United States and the foreign government. However, before the basic agreement can be signed, it must be submitted to section 36 (b) procedures. This exemption permits the type of mixed commercial-FMS sales used by Northrop. In 1979, the first use of this provision occurred involving the sale of 68 F-5E and F-5F aircraft to Korea on a coproduction basis.

In effect, the Congress already has veto power over commercial sales, that is, those FMS sales of \$35 million or more that would have been commercial without the ceiling. If the Congress were to adopt a section 36 (b) procedure (legislative veto) for commercial arms sales, it would have the choice of several thresholds. It could be identical to the FMS thresholds, which is all sales of MDE over \$7 million or more and all other sales of \$25 million or more. This would actually result in an increase in congressional control, because currently the ceiling permits MDE commercial sales up to \$35 million. Additionally, commercial sales of non-MDE items are

not now subject to the ceiling or congressional veto. <sup>1/</sup> Another possibility would be to keep the same level of congressional control that existed in 1976 when the ceiling was first enacted. Simply require all commercial sales of \$25 million or more to be submitted under section 36 (b). Rather than expanding the congressional veto, this option would ensure the retention of the veto power over those sales which have been forced into the FMS channel since 1976. A third threshold would be the \$35 million level of the current ceiling. Thus, the Congress could establish a legislative veto over MDE sales exceeding \$35 million, retaining the same level of authority it has with the ceiling now.

Initially, the proposed Senate amendment to the Arms Export Control Act contained a congressional veto over MDE commercial sales of \$25 million or more. A later version would have subjected commercial MDE sales to a \$7 million threshold for congressional veto and retained the \$25 million commercial sales ceiling. The conference committee agreed to delete the congressional veto authority for commercial exports. The executive branch opposed application of the legislative veto to commercial sales then and now.

Companies were about evenly divided on whether they preferred to keep the ceiling or eliminate it and add a congressional veto. No company wanted both the ceiling and the veto. Most companies in favor of the veto wanted the congressional review as soon as possible after a contract is signed. They opposed imposition of this review prior to the negotiation or finalizing of a contract. Those companies that were skeptical of the congressional veto would probably not be as affected by it since they are not as affected by the ceiling itself. State Department officials pointed out that subjecting commercial sales to section 36 (b) procedures would reduce the time advantages of the commercial channel.

#### DECLARE PREFERENCE FOR FMS

The Congress could insert a clause in the legislation that the U.S. Government prefers major defense equipment sales to be arranged through FMS, but that exceptions would be

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<sup>1/</sup>Currently, Congress receives prior notification of any applications to export MDE valued at \$7 million or more or defense articles for \$25 million or more. Congress also receives a quarterly report on all MDE sales of \$1 million or more. See section 36 (c) and 36 (a)(4) of the Arms Export Control Act.

permitted on a case-by-case basis. This approach was taken in the early 1970s, except that the stated preference at the time, was for all sales to be on a commercial basis.

State Department officials expressed concern about what criteria would be used for granting exceptions. Among the possible criteria are the

- item has traditionally been sold commercially;
- country has purchased the item commercially in the past; or
- country requests permission to purchase the item commercially.

The Congress could retain its control by subjecting commercial sales of MDE of \$25 million or more to a veto. A POD official commented that it was more important to develop explicit criteria for the type of equipment which must be sold FMS.

#### AUTOMATICALLY ADJUST CEILING FOR INFLATION

The Congress could add a clause to the current-ceiling legislation, providing for an annual adjustment based on the rate of inflation. The Congress has accepted the premise that the same volume of commercial sales should be permitted today as in 1976. This alternative would accomplish the objective if inflation is considered the sole cause of higher prices. Companies, however, cited price increases in excess of the inflation rate (20 percent from 1976 to 1979) as a result of product improvement. For example, Boeing-Vertol's average fly-away cost of its CH-47 helicopter increased almost 60 percent from 1976-79 (based on quotes by delivery year). FMC Corporation estimated a 35-percent price increase from 1976-79 on its armored personnel carriers. The base price of Lockheed's C-130H has increased about 40 percent.

#### RAISE CEILING SUBSTANTIALLY

The Congress could raise the ceiling substantially higher than the current \$35 million. Most company officials indicated that a \$50 million ceiling would solve the majority of their problems. If the ceiling were \$75 million, they would have few, if any, problems. Aerospace companies, however, said a ceiling set at \$100 million or higher would be more realistic.

A large increase in the ceiling would thus alleviate the current problems experienced by most companies. It would give companies more marketing flexibility and countries more purchasing flexibility. At the same time, the Congress would still receive the most significant sales of MDE, for example, tanks, missiles, and jet aircraft. As discussed in chapter 3, only 14 sales in 1978 were between \$35 and \$75 million.

This alternative would solve the inflation problem for the next several years. However, eventually the ceiling would have to be adjusted again to ensure that companies are still able to sell the same quantities as in 1976. It would not solve the problem of large quantity sales of MDE with a low unit price versus small quantity sales with a high unit price. Which sale deserves more concern and review--250 armored personnel carriers, 100,000 rifles, or 2 transport aircraft?

#### ADD WAIVER TO CEILING

The Congress could keep the ceiling and add a clause to the legislation that the President or Secretary of State could waive the requirements under certain conditions. This would provide an avenue for relief from the ceiling, but it might not be of much practical benefit. Formal waivers are usually viewed as an emergency measure. It might also be difficult to reach agreement as to which situations would qualify. Those companies whose sales do not qualify may complain that they were discriminated against.

#### REDEFINE TRANSPORT AIRCRAFT AND HELICOPTERS

The International Traffic in Arms Regulations could be amended to redefine transport aircraft and helicopters. The U.S. Munitions List, published in the ITAR, divides arms, ammunition, and implements of war into 22 categories. Category VIII covers "Aircraft, Spacecraft, and Associated Equipment" with subparagraph (a) defining cargo-carrying or -dropping aircraft and helicopters as significant combat equipment. Category VIII (a) could be divided into 2 sections. One section could contain cargo-carrying or -dropping aircraft and helicopters without a significant combat equipment designation. The other section could retain its significant combat equipment designation but exclude cargo-carrying aircraft and helicopters.

This alternative would solve the ceiling problem for the manufacturers of cargo-carrying aircraft and helicopters. Since these are normally high-unit cost items, the present ceiling permits the sale of only a small number on a

commercial basis. As a result, companies contend that sales are being lost or reduced. It would raise, however, the issue of equitability by other companies who might feel that their item should also not be considered significant combat equipment. For example, Olin Corporation said that most countries treat ammunition as spare parts or supplies. Olin feels that it is not marketing a system, but rather that the ability to use ammunition is limited by prior purchases of airplanes or guns.

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