

REPORT BY THE

# Comptroller General

OF THE UNITED STATES

## U.S. Assistance To The State Of Israel

The major objectives of U.S. assistance to Israel include demonstrating U.S. political support for an ally and providing for the defense of Israel. Israel receives more U.S. security assistance and also more liberal terms and concessions than other countries. However, it continues to seek additional help because it perceives potential threats from other Middle East nations which, in some cases, also obtain advanced U.S. weaponry. The Congress has approved increases in the Israeli program and included more grants and forgiven loans. Even so, Israel is faced with the need to finance new military loans as well as to make payments on older outstanding loans.

GAO believes the trends toward increasing assistance requirements, greater relaxation of restrictions on the use of security assistance funds, and the provision of assistance under terms others may ask for will continue unless Israel can reach a peaceful settlement with its Arab neighbors. Without this, the United States is faced with questions concerning the spiraling Middle East arms race, the impact of providing concessions with assistance, and the Israeli military debt situation.



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JUNE 24, 1983

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

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The Honorable Charles H. Percy  
Chairman, Committee on Foreign  
Relations  
United States Senate

The Honorable Clement J. Zablocki  
Chairman, Committee on Foreign  
Affairs  
House of Representatives

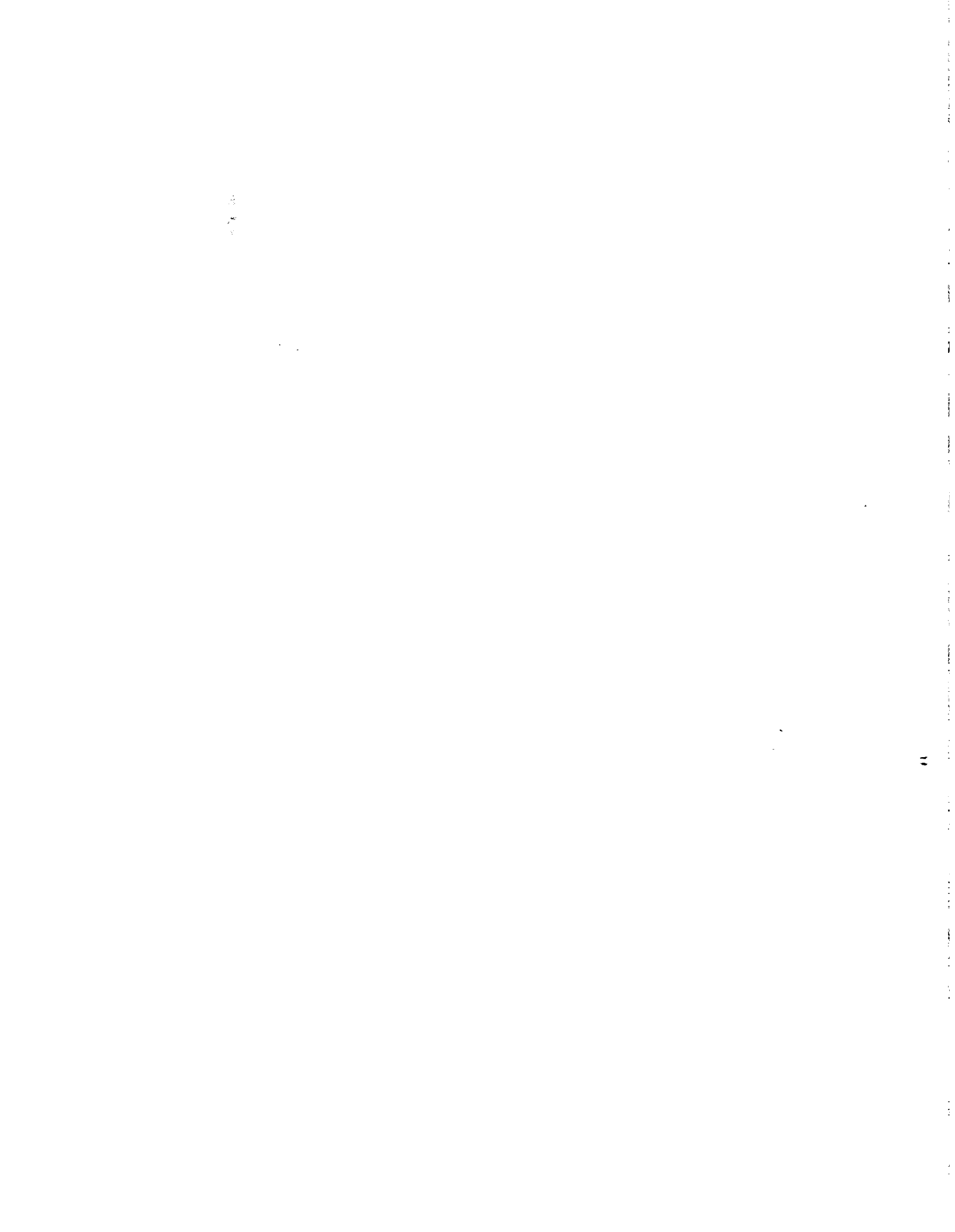
This report is the unclassified version of our classified report that describes the full range of security assistance to Israel and the U.S. policies which govern this assistance.

The report is one of a series on security assistance and arms sales to and security commitments with key Middle East countries.

We are sending copies of this report to the Director, Office of Management and Budget; the Secretaries of State, Defense, the Treasury, and Commerce; the Director, Central Intelligence Agency; the Administrator, Agency for International Development; and other appropriate congressional committees.

A handwritten signature in cursive script that reads "Charles A. Bowsher".

Comptroller General  
of the United States



D I G E S T

The United States has furnished assistance to Israel since 1948. (See p. 1.)

--Aid levels have increased significantly since 1973 and in fiscal year 1982 exceeded \$2 billion (Foreign Military Sales (FMS) and Economic Support Fund (ESF)). (See pp. 8 and 30.)

--Following the 1979 Camp David Accords, Israel remained the largest recipient of U.S. economic and military security assistance and Egypt became the second largest.

The size of this program, along with its interaction with military assistance and arms sales to other countries in the important Middle East region, led GAO to review the security assistance and related programs for Israel. The review covered justifications for assistance, its use, and its contributions to U.S. and Israeli interests and objectives. This is one of a continuing series of GAO reviews of assistance programs and security commitments with recipient countries.

The U.S. commitment to Israel has a long history dating back to President Truman's recognition of Israel on May 14, 1948. This commitment is predicated upon shared cultural, religious, moral, and political values. The commitment is not couched in terms of any specific agreement such as a mutual security pact and the United States has followed a policy of step-by-step diplomacy in seeking to resolve various issues. (See p. 2.)

SPIRALING ARMS TRANSFERS TO  
THE MIDDLE EAST

The major objectives of U.S. assistance to Israel include demonstrating U.S. political

support for an ally and providing for the defense of Israel. (See p. 6.) At the same time, however, the United States has a variety of interests in assisting Arab states in the Middle East and arms transfers to these Arab states are increasing as well. (See pp. 2, 3, 12 and 13.)

As arms transfers to Arab states increase, Israeli officials believe that they must contend with the possibility of fighting nations which have acquired additional and improved equipment. As a result, perceptions of Israel's arms needs increase and this contributes to a spiraling arms transfer effect in the Middle East.

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#### PRECEDENT SETTING FEATURES OF THE ISRAELI PROGRAM

Besides the size of the program, Israel has asked the United States for, and has already received to some degree, assistance under liberalized financing methods. Were these liberalized terms not provided, additional assistance may have been requested.

GAO takes no position on the level or terms of assistance to Israel but believes the precedents being set by the liberalized financing methods should be continually considered against the possibility that other recipient countries will ask for similar concessions. Examples of granted liberalized financing techniques follow:

--Israel was the first beneficiary of the cash flow method of financing which allows a country to set aside only the amount of money needed to meet the current year's cash requirement for multi-year production contracts rather than the full amount. Egypt was subsequently authorized use of the cash flow method. This has allowed the countries to

stretch buying power and place more orders than the available loans authorized in a given year. It appears to GAO that this implies a commitment for the Congress to approve large financing programs in future years to ensure that signed contracts are honored. (See pp. 20 through 22.)

--Israel has been forgiven (allowed write off of) a substantial portion of the FMS loan program (\$750 million of \$1.7 billion for fiscal year 1983). Now other countries have received the same benefit (Egypt and Sudan). Israel has also requested and received the forgiven portion of the FMS loans before drawing down the interest-bearing repayable, part of the loans. This defers interest expenses for the Israeli Government. (See pp. 19, 20, 21, and 23.)

--Israel will receive an ESF grant totaling \$785 million in fiscal year 1983, making it the largest program recipient. Funds are provided to Israel as a cash transfer, not tied to development projects as is the case for many other countries. (See pp. 27 and 28.)

--Israel receives trade offset arrangements from U.S. firms when it makes FMS purchases. Offsets are commitments by U.S. firms to purchase a specified amount of Israeli goods or services. Such arrangements are common under commercial arms sales but unusual under FMS in that the administration believes these funds were intended by the Arms Export Control Act, for purchase of materials and services in the United States. (See pp. 52 through 55.)

--Israel, more than any other FMS recipient country, has been provided with a higher level of military technologies having export potential. Although the United States retains legal control over export of these items to third countries, this could have an adverse impact on the U.S. economy and can affect U.S. ability to control proliferation of these technologies. (See pp. 42 through 44.)

Israel has also asked for additional concessions to assist in further stretching its assistance. For example:

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--Israel requested in 1982 that ESF funds be disbursed in a single payment at the beginning of the year. This would cost the U.S. Government in excess of \$40 million in interest annually when compared to the usual quarterly disbursement of ESF funds. This is currently done only for Turkey, as part of an understanding with other donors. Israel was advised that the United States preferred to continue with quarterly disbursements and did not renew this request in fiscal year 1983. (See pp. 33 and 34.)

FINANCING ISRAEL'S  
INCREASING REQUIREMENTS

Even though large amounts of the FMS loans for Israel have been forgiven, there remains a large loan element. Debt servicing of these loans is of concern to Israel and the amounts owed will increase in the near future. In fiscal year 1983, Israel will repay the United States about \$887 million for interest and principal on outstanding FMS loans. Israeli military debt repayments will rise from a projected \$906 million in 1984 to about \$1.1 billion in 1992. (see pp. 37 through 40.)

The United States and Israel are faced with the necessity of financing the increasing requirement for new purchases as well as the repayments of outstanding loans. (See pp. 38 and 41.)

SOME QUESTIONS FACING  
THE UNITED STATES

GAO believes the trends toward increasing assistance requirements, greater relaxation of restrictions on the use of FMS funds, competition with U.S. production, and setting of



precedents that others may seek to emulate will continue as long as Israel feels militarily threatened by its neighbors in the region. It is clear that the ultimate solution to Israel's security depends upon a negotiated settlement with its Arab neighbors.

Overall, the United States is faced with questions regarding the assistance program for Israel, along with other countries, that are not easily resolved. Among these are:

1. What is the impact of U.S. programs and policies on the spiraling Middle East arms escalation?
2. To what extent do concessions to Israel make it difficult to resist other recipients which might ask for similar concessions and what are the potential impacts and increased costs to the United States?
3. To what extent might Israel ask for increased U.S. assistance levels and concessions to be able to repay mounting debt-servicing requirements to the United States?

#### AGENCY COMMENTS

The Departments of State, Defense, and the Treasury, the Central Intelligence Agency and the Agency for International Development (AID) have provided comments on this report which have been incorporated where appropriate. Defense, Treasury, and AID concurred with the general thrust of the report. The Department of State positively noted the comprehensive nature of the report. Most of the agencies comments dealt with updating information and clarifications.

The Department of State, AID, and GAO agree that Israeli debt is rising, but there are different opinions as to its implications. State Department foresees no development of a severe debt situation and AID reported cause for optimism regarding Israel's balance of payments prospects. GAO noted the rising FMS repayment demands may lead to more pressures to increase assistance.

The Department of State noted that this review portrayed the arms growth in the region as the outgrowth of the Arab-Israeli dispute. GAO concurs in that, if taken alone, this report highlights the Arab-Israeli focus of the regional arms race. The multiplicity of factors that affect arms transfers are presented by various recent GAO reports on the subject area. Nonetheless, the Arab-Israeli dispute remains a major element of the growth of arms transfers to the region.

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## CHAPTER 1

### INTRODUCTION

The continuity of the U.S.-Israeli relationship is a key tenet of U.S. policy in the Middle East. Israel as a stable democracy and the region's strongest military power, is considered by the United States to be a strategic asset in the Eastern Mediterranean against a Soviet threat. Nonetheless, some problems have surfaced regarding the relationship as the United States has attempted to reconcile its commitment to Israel with its other commitments and interests in the Middle East. Meanwhile, U.S. assistance programs for the defense of Israel have steadily increased and each U.S. President has restated the strong U.S. support for Israel.

### U.S. ASSISTANCE TO ISRAEL

U.S. assistance to Israel from 1948 through fiscal year 1983 totaled over \$25 billion. This includes

- over \$16.5 billion in military loans and grants;
- over \$6.5 billion in economic assistance loans and grants under the security assistance program; and
- over \$2 billion in other nonsecurity assistance programs which include Food for Peace, housing guarantees, Export-Import Bank loans, and aid for resettling Jews from the Soviet Union.

Since 1974, almost half of Israel's military assistance has been in the form of grants and, since 1979, economic aid has been entirely a cash transfer, meaning that funds are not linked to specific projects or commodity imports. However, Israel is required to make assurances that it is purchasing at least the same amount of non-defense goods from the United States as it receives for economic aid. This assistance is to be used for non-military purposes. Israel has also agreed, in side-letter arrangements, to follow procedures for using U.S. ships to transport 50 percent of Israeli grain purchases from the United States, and to purchase the same volume of grain as it did under the commodity import program.

U.S. military assistance to Israel exceeds assistance to any other country and continues to rise. At \$1.7 billion, the fiscal year 1983 Foreign Military Sales (FMS) level is 21 percent above 1982, larger than for any other FMS recipient. The

level for economic assistance, in the form of the Economic Support Fund (ESF), is \$785 million which is also more than any other recipient, excluding the PL-480 program for Egypt.

#### U.S. COMMITMENT TO ISRAEL

The United States has a commitment to Israel's continued national existence. It is rooted in shared cultural, religious, moral and political values. It dates back to President Truman's recognition of Israel on May 14, 1948. The commitment is not couched in terms of any specific agreement such as a mutual security pact. Rather, the United States has followed a policy of step-by-step diplomacy, within our shared values, in seeking to resolve various issues that have arisen in the area.

#### U.S. ROLE IN THE MIDDLE EAST

The United States and Israel are in general agreement concerning the nature and extent of the Soviet threat to the region. However, the Israeli Government is concerned about U.S. efforts to assist various Arab countries to improve their military forces and thus achieve a strategic consensus against the threat of Soviet intrusion into the region.

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Every U.S. President from Truman to Reagan has been involved in the formidable task of reconciling the Arab-Israeli conflict. Peace in the Middle East would remove many of the pressures and tensions on the United States in trying to serve its common interest with some of these countries but which for years have been engaged in internal regional conflicts. On the one hand, the United States has not yielded from its commitment to assist Israel to maintain its economic health and qualitative military superiority. At the same time, however, the United States has sought to increase friendly relations with various Arab nations which continue to resist the recognition of Israel as a country. Certain Arab countries such as Saudi Arabia, are an important source of oil for the United States, Western Europe, and Japan. Other Arab countries in the Middle East serve to check what the United States perceives as Soviet expansion in the region.

The United States has participated in a succession of diplomatic efforts to help resolve the seemingly intractable Arab-Israeli conflict. This role escalated in 1975 when the United States agreed to act as "the eyes and ears of peace" by setting up a civilian watch in the Sinai. The United States

played a major role in promoting peace in the Middle East through a settlement between Israel and Egypt at the Camp David Summit in September 1978, followed by a formal peace treaty in March 1979. The treaty provided for the two countries to establish diplomatic relations for the first time, for Israeli withdrawal from the Sinai Peninsula in 3 years, and for the deployment in the Sinai Peninsula of a multinational peace-keeping force to supervise implementation of the treaty. The Camp David Accords provided a forum for negotiations on the future of the West Bank and Gaza Strip.

On September 1, 1982, President Reagan set forth his Middle East initiative to be a fresh start in the peace process but which also reaffirmed an ironclad U.S. commitment to Israel's security. This was predicated on particular events which had taken place over the three intervening years since the Camp David Accords. The administration recognized that not enough progress was being made in bringing about the comprehensive peace of the Camp David Accords. Secondly, the United States had succeeded in obtaining a negotiated withdrawal of Israeli and PLO forces from Beirut, Lebanon. Furthermore, the administration also believed that Israel's continued settlement activity in the West Bank and Gaza and the continued U.S. silence on this issue, gave the impression of tacit endorsement of Israeli actions.

#### OBJECTIVES, SCOPE, AND METHODOLOGY

The objectives of the review were to examine the full range of assistance to Israel and the U.S. policies which govern this relationship. Specific issues addressed were:

- The relationship which exists between the United States and Israel, and how this relationship is translated into policy objectives.
- The major determinants of aid levels to Israel and the extent to which there is information within the U.S. Government as to the use of these funds.
- The effect of U.S. aid on Israel's economy and is it meeting U.S. and Israeli objectives.
- The full range, status, implementation, and impact of the U.S. commitments to developing the Israeli arms industry--current and proposed.
- The use of funds and support provided to Israel pursuant to the Camp David Accords and the initial operations of the Multinational Force and Observers.

## Scope

We conducted our review at the Departments of State, Defense, the Treasury, and Commerce; the Office of Management and Budget; the Central Intelligence Agency; and the Agency for International Development; and the American Embassy in Tel Aviv, Israel. We also obtained relevant data from and interviewed responsible Israeli officials from the Israeli Embassy, Washington, D.C.; the Israeli Military Procurement Mission, New York, N.Y.; the Ministries of Foreign Affairs, Defense (including component services), and Finance; and the Knesset. We also interviewed U.S. and Israeli industry representatives involved in defense industries.

## Methodology

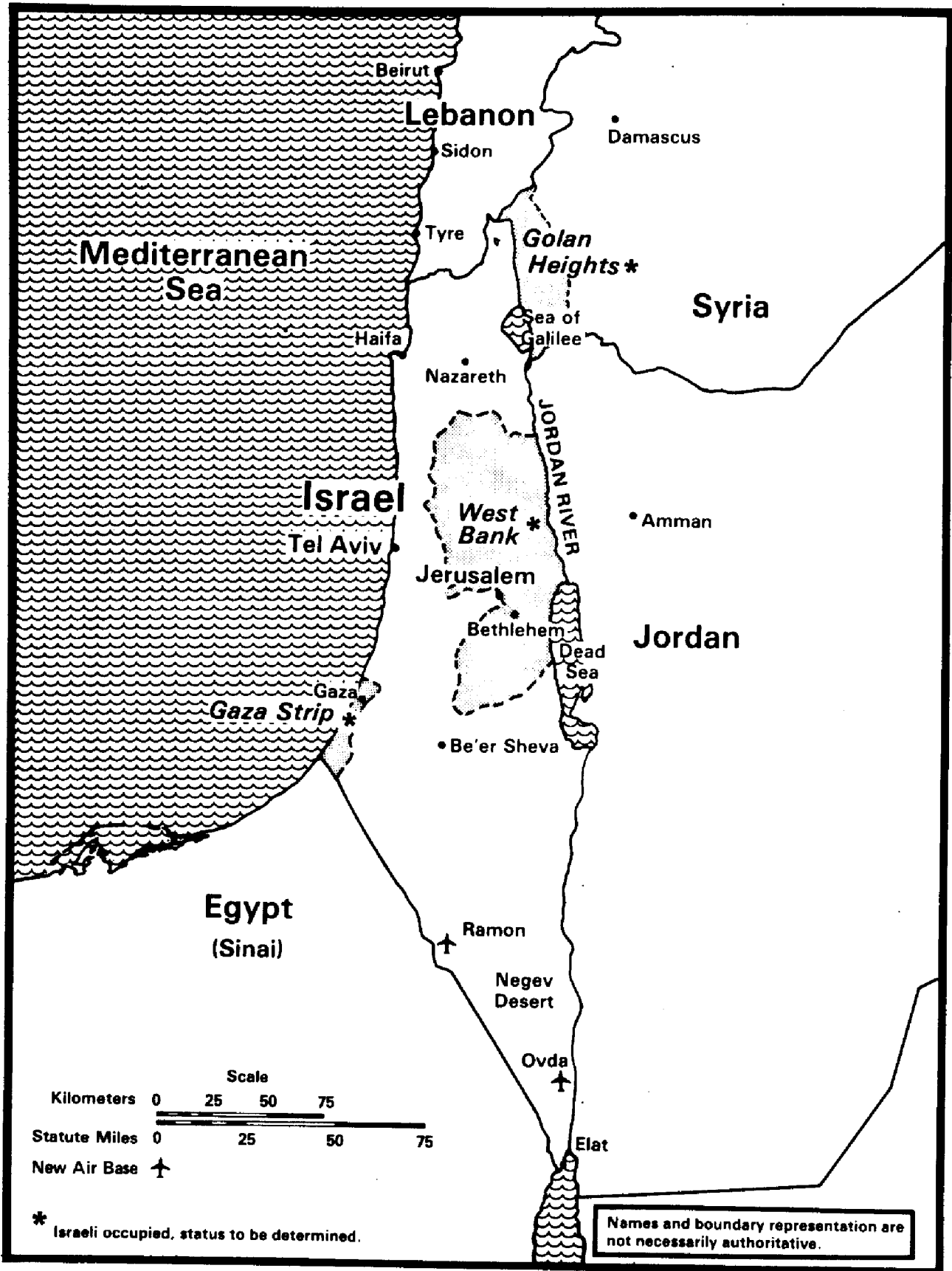
In the course of the review, we

- examined pertinent laws, regulations, and instructions;
- conducted literature searches;
- obtained and reviewed appropriate State, DOD, and private sector studies and reports;
- interviewed appropriate U.S. and Israeli military and civilian officials;
- visited selected Israeli defense industries and interviewed appropriate officials;
- reviewed files and records in order to obtain relevant data at all levels visited; and
- conducted pertinent economic and statistical analyses of U.S. financial assistance programs to Israel.

The review was carried out in accordance with generally accepted government auditing standards. Information relative to any threat assessment, Israel's defense posture, and the needs of Israeli armed forces were accepted from responsible U.S. and Israeli officials without verification. The rationale and reasons for the Israeli assistance program were accepted as set forth by the responsible U.S. officials.



# ISRAEL



## CHAPTER 2

### FOREIGN MILITARY SALES ASSISTANCE

Foreign military sales to Israel, the largest U.S. military aid program, serves two major purposes. One is to indicate U.S. political support for Israel and the other is to ensure the security of Israel by providing military equipment for its defense needs.

Israeli military needs and U.S. political influences are both factors which determine FMS levels. The administration does evaluate Israeli military requirements, and the Congress also plays an important role. The Congress places more attention and exerts more influence on assistance to Israel than on other assistance programs.

Although its military has never been more modern and capable, Israel believes it has continuing modernization needs because of a potential Arab threat. Israel uses its FMS assistance for modern weapon acquisitions and other defense imports from the United States. Increasing U.S. and Soviet arms sales to other Middle East countries has led to a spiraling effect on weapons sales and assistance levels.

The United States generally supports Israeli plans for its forces modernization, and agrees that there is an Arab threat to Israel.

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The relationship is also exemplified by flexible terms and conditions for Israeli procurements with FMS assistance. Israel obtains more grants than any other recipient, has long term loans, some at special rates, and is allowed to order military equipment under special financing arrangements before full funding is authorized by the Congress. Furthermore, during fiscal year 1982, it had been authorized to obtain its grant funds before its loan funds for military purchases--this allows Israel to defer for many years interest payments of approximately \$19 million. Moreover, the Administration has reported several times to the Congress that Israel's use of U.S.-controlled military equipment may have violated the agreements under which they were transferred.

DEVELOPMENT OF MILITARY ASSISTANCE  
TO ISRAEL

The United States has had a formal military assistance relationship with Israel since 1952, but did not become its major supplier of arms until after the Six Day War of 1967. The annual large U.S. military assistance program began after the October War of 1973. In 1962, some U.S. military loans were made and in 1966, the United States agreed to ensure the sale of arms to Israel, if not from Western sources, then from the United States. Hawk air defense missiles and A-4 fighters were sold to Israel but the major suppliers of military equipment remained: the British for tanks and the French for aircraft. After the Six Day War of 1967, France discontinued its aircraft sales and the United States began sales of the F-4 aircraft. U.S. military assistance to Israel totaled more than \$1.4 billion for fiscal years 1950 through 1973. In fiscal year 1983, the military assistance is \$1.7 billion in grants and loans. (See chart on page 8.)

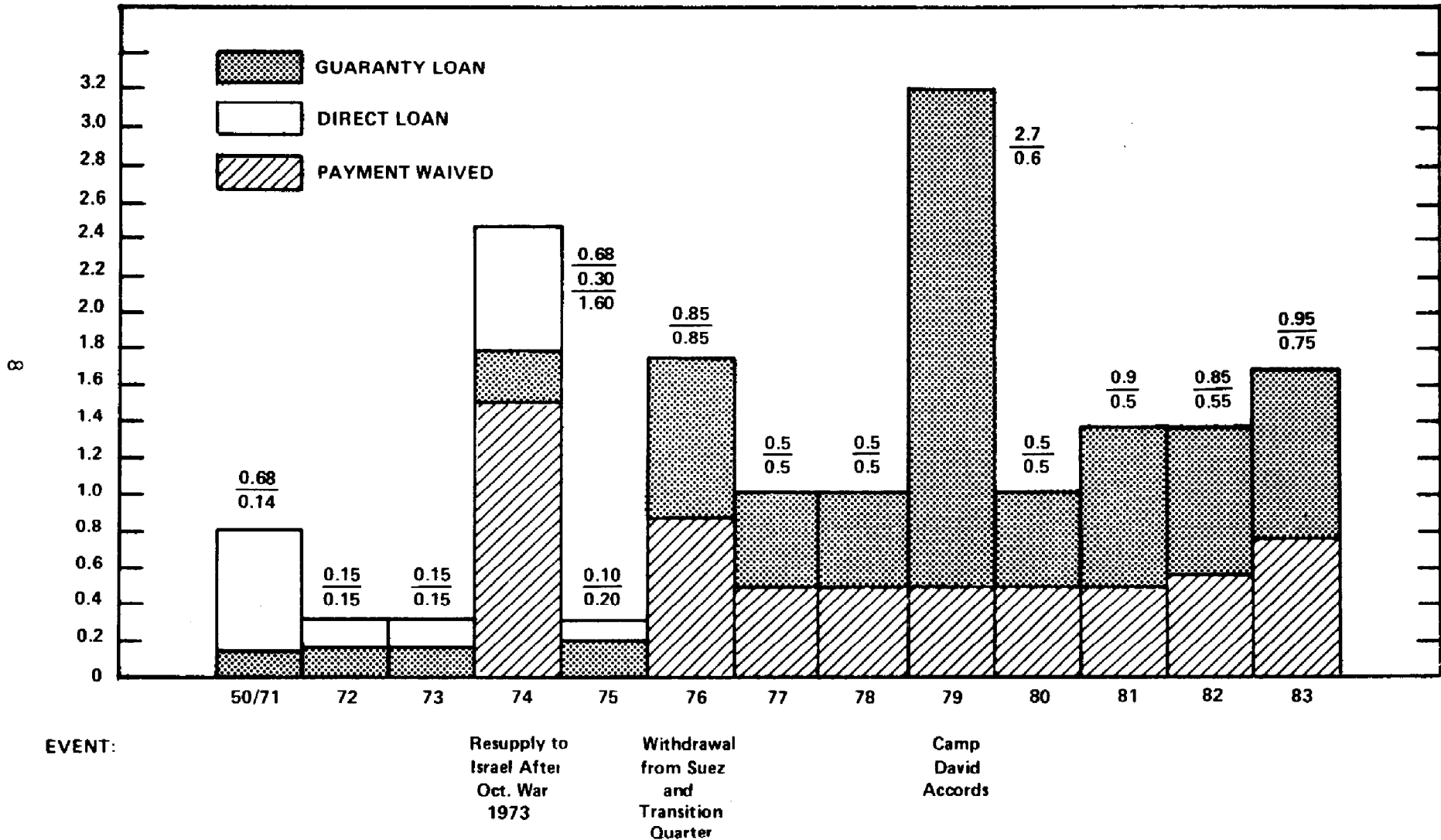
FMS ASSISTANCE LEVELS FOR ISRAEL

Since 1974, Israel has been the recipient of more FMS assistance than any other country. Through fiscal years 1974 to 1982, Israel received almost \$13.5 billion in FMS assistance. Of this total, \$5.4 billion was in the form of grants while about \$8 billion was in long term loans. In fiscal year 1982, Israel was authorized \$1.4 billion in FMS financing which was 33 percent of the total U.S. military assistance program. Egypt obtained \$900 million while all other recipients combined received less than \$1.6 billion.

The administration proposed increasing Israeli FMS to \$1.7 billion for fiscal year 1983 and Egyptian FMS to \$1.3 billion. The Israeli program was proposed to include a grant element of \$500 million and long term loans for the other \$1.2 billion. The Congress approved \$1.7 billion FMS assistance to Israel and raised the grant element to \$750 million. Israeli documents show that U.S. assistance funded 37 percent of its defense budget for fiscal year 1982.

Assistance levels appear to be related to political events, as shown in the chart on page 8, which portrays the interplay of events and increases in Israel's levels of FMS assistance. The levels stabilized at \$1 billion per annum during fiscal years 1977 to 1980, except for \$2.2 billion specifically allocated in 1979 for withdrawal from the Sinai. Otherwise, FMS assistance rose above the general trend in two circumstances. The first time was for Israeli rearmament after the October 1973 War when FMS assistance reached \$2.5 billion in fiscal year 1974. The second was when Israel obtained \$1.7 billion in loans and grants in fiscal year 1976, after Israel's second disengagement in the Sinai.

**FMS LEVELS TO ISRAEL AND EVENTS DURING  
INCREASES OF ASSISTANCE  
(FISCAL YEAR—U.S. \$ BILLIONS)**



Source: Department of Defense, Events added by GAO.

Israel requested an additional \$200 million in FMS assistance for fiscal year 1981 for financing additional redeployment costs associated with implementation of the Egypt-Israel Peace Treaty. The administration agreed, and made the request to the Congress, which added another \$200 million and the FMS assistance level rose to \$1.4 billion for fiscal year 1981. This same amount of assistance was continued into fiscal year 1982.

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#### Congressional role

The Congress consistently views administration aid proposals for Israel favorably, and in recent years, has appropriated more aid for Israel than the President requested. When the executive branch requested a shift from the commodity import financing to cash assistance in 1978 the Congress earmarked Israeli security assistance to provide Economic Support Fund (ESF) on a cash basis, included larger amounts of forgiven FMS loans, and granted favorable repayment terms for arms purchases. For example, for fiscal year 1982, the Congress approved \$50 million more in FMS grants than the administration requested. Again for fiscal year 1983, the Congress approved \$750 million in FMS grants although the administration had proposed only \$500 million in grants.

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Foreign policy considerations

Many consider FMS assistance as a policy statement of U.S. support for Israel.

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We were told that decisions regarding FMS are made at the highest levels of the administration.

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The assistance levels are determined by policy considerations beyond those involving only basic defense needs.

FMS to Israel linked with Egypt

The Egyptian and Israeli FMS assistance programs are politically tied to each other and are becoming more difficult to separate. The Egyptians have been requesting treatment similar to the Israelis since Camp David. This is reflected in higher levels of assistance, similar terms of FMS repayment, similar uses of cash flow (see p. 20), and similar desires for advanced equipment.

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ISRAELI MILITARY NEEDS

U.S. and Israeli officials agree that Israel has security problems which require FMS assistance. However, there is growing concern in Israel over the level of FMS due to: increasing U.S. arms sales to Arab countries; erosion of its qualitative advantage; and Israeli force modernization needs.

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Effect of other U.S. Middle East arms sales and assistance

U.S. arms sales and FMS assistance to Israel are not only linked to Egypt but also to certain other Arab countries which have or can get the funds to pay for these arms. Arms sales to an Arab State in the region generally have led to another sale to Israel or increased FMS to offset Israeli security concerns. This, Soviet sales, and the floor effect have resulted in a spiral of arms sales to the region and assistance levels.

Current controversy in arms sales to the Arabs began with the sale of F-15 aircraft to Saudi Arabia in 1978. When the administration presented its case for the sale, it said this was not a single sale but a package of aircraft sales to three Middle East countries, with 15 F-15 and 75 F-16 aircraft going to Israel, 60 F-15 aircraft to Saudi Arabia, and 50 F-5E aircraft to Egypt.

The Carter administration said the package approach enhanced U.S. interests in the region and those of all three recipient countries. It also helped ensure the security of Israel, which opposed the sale of the F-15 aircraft to the Saudis, by helping to maintain the balance of Arab and Israeli air forces in the Middle East region. The administration linked the sales to the three countries so that it was more difficult for the Congress to isolate action on the Saudi F-15 aircraft sale from action on the aircraft sales to Egypt and Israel.

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Israel takes a pessimistic view of the trend of U.S. arms sales to Arab countries and fears that the focus of U.S. regional concern is shifting toward the Persian Gulf and Saudi Arabia.

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Israeli concerns for threat from the region

Israelis are particularly sensitive to the level of casualties they might sustain in a full-scale war with the Arabs.

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Although some of Israel's potential adversaries are obtaining the same generation of technologically advanced weapons, U.S. officials point out that Israel retains greater operational effectiveness of its forces. This is attributable to superior leadership, morale, training, motivation, and the ability to employ and maintain advanced technology weapons. Acquisition and integration of command, control, and intelligence systems complement Israel's ability to employ its forces more effectively than the Arab States.

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Differences in view of the threat

In general, U.S. officials agree with Israel that the Middle East is a very unstable area and will continue to be so for the foreseeable future. Both countries agree that there are Arab States which pose a potential threat to Israel. However, the United States does not concur with all Israeli assessments concerning the threat.

Israel views its immediate threat as the military forces of

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The balance of military forces between the Arabs and Israel is considered to remain in the Arabs favor by Israeli military planners. Additional Israeli concern is voiced over Western and Soviet weapon systems sold to the Arabs.

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ARAB ISRAELI MILITARY BALANCE  
MILITARY EQUIPMENT NUMBERS AND RATIOS FOR WORST CASE

Equipment

Tanks  
Armored Carriers  
Artillery  
Combat Aircraft  
SAM Batteries  
Combat Brigades

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Israel force modernization needs

The U.S. assessment of Israeli needs is somewhat lower than the Israeli estimate.

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In May 1981, the Israeli Ministry of Defense reaffirmed its force structure requirements. The major formation of the Israeli Defense Force would include -- armored divisions, -- mechanized infantry brigades, -- territorial brigades, -- self-propelled artillery battalions, -- fighter squadrons, and -- missile flotillas. Major equipment for this force would

include --- tanks; --- armored personnel carriers; --- artillery pieces; --- combat aircraft; --- attack helicopters; and --- missile boats.

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Israeli military planners have stated that Israel plans to stop the growth of its military at the planned levels and does not expect to expand its force structure. They stress that Israel needs to modernize current forces and maintain the qualitative advantage through acquisition of new and better equipment to replenish its inventories.

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The chart on page 16 shows the major U.S. equipment delivered to Israel thus far.

SELECT MAJOR ITEMS DELIVERED TO ISRAEL UNDER FMS  
1971 -August 1982

AIRCRAFT

|         |   |
|---------|---|
| DELETED | A-4 Aircraft<br>F-15 Aircraft<br>F-16 Aircraft<br>F-4/RF-4 Aircraft<br>E2C Aircraft<br>AH-1G/S Helicopters<br>CH-53 Helicopters |
|---------|---|

GROUND FORCES

|         |   |
|---------|---|
| DELETED | M48 Series Tanks<br>M60 Series Tanks (--- are M60A3 Tanks)<br>M113A1 Armored Personnel Carriers<br>M88A1 Tank Recovery Vehicles<br>M548 Cargo Carriers<br>M577A1 Command Post Carriers<br>M109 155mm Self-Propelled Howitzers<br>M107 175mm Self-Propelled Guns |
|---------|---|

SURFACE-TO-SURFACE MISSILE SYSTEMS

|         |   |
|---------|---|
| DELETED | --- Launchers, --- Missiles<br>DRAGON (Anti-tank) Launchers, --- DRAGON Missiles<br>TOW (Anti-tank) Launchers, --- TOW Missiles |
|---------|---|

AIR DEFENSE SYSTEMS

|         |  |
|---------|--|
| DELETED | I-HAWK Batteries, --- I-HAWK Missiles<br>Chaparral Launchers, --- Chaparral Missiles<br>M163 20mm Vulcan Guns<br>REDEYE Missiles |
|---------|--|

AIR-TO-AIR MISSILES

|         |   |
|---------|---|
| DELETED | AIM-7 Sparrow Missiles<br>AIM-9 Sidewinder Missiles |
|---------|---|

AIR-TO-GROUND MISSILES

|         |   |
|---------|---|
| DELETED | Maverick Missiles<br>Standard ARM Missiles<br>Shrike ARM Missiles |
|---------|---|

SURFACE-TO-SURFACE MISSILES

|         |                  |
|---------|------------------|
| DELETED | Harpoon Missiles |
|---------|------------------|

SOURCE: DEFENSE SECURITY ASSISTANCE AGENCY

Future Israeli major item procurement

DOD agrees with Israel that additional numbers of tanks are needed for modernization.

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Israel has requested 75 additional F-16 aircraft and expressed interest in -----DELETED----- . Although its aircraft on hand and in the pipeline will enable it to maintain a force structure of ----DELETED----- in the longer run, there is a need to replace the Israeli Kfir and A-4 aircraft. Israel plans to do this through their own production of --- Lavi aircraft for which they have requested release of U.S. high technology engines and airframe components. Israel also requests funding assistance for research and development efforts in the United States and Israel, and funding assistance for production of the aircraft within Israel. (See pp. 55 through 60.)

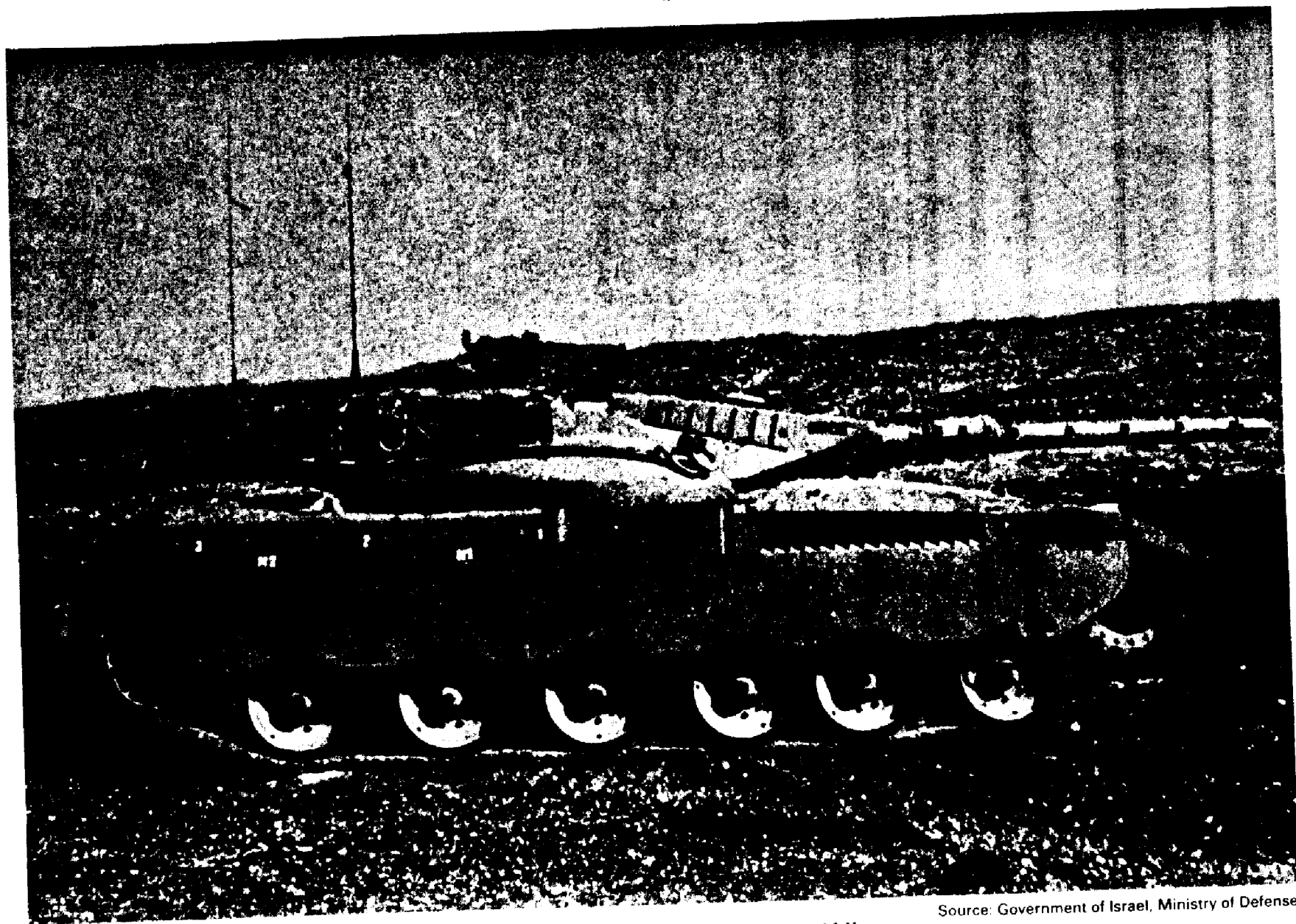
Procurements of at least --- armored personnel carriers are tentatively projected. Israel still has --- World War II half-tracks in its operational inventory and desires to retire --- of them by ---. DOD has approved procurements of these additional carriers.

Israeli plans call for ---DELETED--- self-propelled howitzers per division or a total of --- for an --- division force. Since Israel has --- howitzers on hand or in the pipeline,

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Israeli Main Battle Tank "MERKAVA"

Source: Government of Israel, Ministry of Defense

Limited Israeli equipment losses in Lebanon campaign

Israeli officials maintain there will be no costs to the United States from the Lebanon campaign and DOD officials stated that Israeli equipment losses were limited.

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Israel captured approximately --- Soviet tanks and --- armored vehicles.

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Additionally, -----DELETED-----  
Israel captured --- various artillery pieces; --- tons of artillery shells; --- mortar rounds; --- Katyusha rockets; --- mines; --- hand grenades; --- tons of small arms ammunition; and --- rifles.

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CONCLUSION

There are differences between the United States and Israel regarding the perceived threat to Israel and its military needs. Joint planning groups have been established with other Middle East countries to determine their military needs and to resolve differences such as those that are present regarding Israel. However, considering the other influencing factors, which we discussed above and continued close contacts between Israeli and U.S. officials, it is likely that establishment of such a group for Israel would have limited effect.

FMS FINANCING FLEXIBILITY

The U.S. relationship with Israel is exemplified by the more liberal terms, conditions, and purchasing flexibility of FMS assistance. Israel receives more FMS forgiven loans than any other recipient, more FMS loans with long term repayment periods, and its procurement of military systems has been expanded through an administrative mechanism called cash flow financing.

### FMS forgiven loans

In the fiscal year 1983 program, \$750 million of the FMS loans for Israel were designated as forgiven and do not have to be repaid. Egypt was also allocated \$425 million in forgiven credits.

Since 1974, the United States has forgiven part of the FMS loans provided to Israel, which, in effect makes those funds grants. From 1976 through 1980, not including the Sinai redeployment aid, the forgiven portion of the loans usually reflected one-half the level of FMS assistance for that year. After FMS assistance passed the \$1 billion level in 1981, the figure \$500 million was substituted in lieu of "one-half" the FMS assistance level. The forgiveness portion was increased by the Congress to \$550 million in 1982.

For fiscal year 1983, the administration had proposed forgiving \$500 million of a total \$1.7 billion FMS package for Israel. Israel has requested a return to the formula of one-half forgiven and one-half loan for its FMS assistance. Under the continuing resolution for fiscal year 1983, the Congress approved \$750 million of forgiven FMS credits out of the \$1.7 billion FMS assistance package.

### FMS loan repayment

Israel has long term repayment of 30 years on its FMS loans, in contrast to what has been the usual maximum repayment period of 12 years for most recipients. Conditions of repayment are a 10-year grace period on repayment of principal followed by 20 years for repayment of interest and principal. Interest rates for FMS loans are based on interest rates charged the U.S. Treasury for its outstanding marketable obligations plus a nominal administrative fee. In addition to Israel, other countries now allowed these more liberal repayment terms for FMS loans include Egypt, Greece, Somalia, Sudan, and Turkey.

### Cash flow financing

In addition to liberal terms for repayment of FMS assistance, Israel also has more flexibility in the procurement of U.S. military goods than almost all other FMS recipients. This flexibility is referred to as cash flow financing. In effect, it allows Israel to order military equipment based on future FMS expectations which have not yet been authorized by the Congress. It has been allowed to use this financing method since 1974. Egypt was permitted cash flow privileges after Camp David and, more recently, Turkey also was granted cash flow for certain FMS procurements. As we reported in 1982<sup>1</sup>, cash flow financing

<sup>1</sup>Report to the Congress "Forging a New Defense Relationship With Egypt" (ID-82-15, Feb. 5, 1982). Report to the Honorable William Proxmire, Joint Economic Committee, "U.S. Security and Military Assistance: Programs and Related Activities" (GAO/ID-82-40, June 1, 1982).



implies a strong commitment by the United States to provide large amounts of credit in future years, limiting, in our view, the prerogatives of the Congress in authorizing the U.S. security assistance program.

When a weapons system is purchased, the buyer signs an agreement specifying the dates of equipment deliveries and the payment schedule. While the total cost of an item may be tens or hundreds of millions of dollars, not all the money will be paid in the first year after the contract is signed. Major systems have a long lead time before delivery, usually several years, and payments will be spread out over this time period.

Under normal FMS financing procedures, the United States requires that the buyer reserve, or set aside, the full cost of the item when the order is placed. This means that if an item costs \$100 million, FMS credits of \$100 million must be set aside when the agreement is signed, even though actual payments may be made years later. This is to ensure that a country will have all the funds necessary to pay for the item it has ordered.

With the cash flow system, however, the country sets aside only the amount of money needed to meet the current fiscal year's cash requirements. The payment schedule for a \$100 million item, for example, may require that only \$50 million be paid the first year. Under the cash flow system, Israel can set aside only \$50 million and use the other \$50 million to place additional orders. Thus Israel expects FMS credits to be authorized the following year by the U.S. Congress. Should the Congress not authorize these credits, Israel nevertheless would remain contractually bound to pay the \$50 million due the second year from other monies available to it. As a practical matter, however, it is unlikely that the Congress would refuse to authorize FMS credits sufficient for Israel to meet its contractual obligations. This could severely limit the flexibility of the Congress in authorizing future FMS credit programs.

Israel used cash flow financing during fiscal years 1976 through 1980 to pay for the procurement of its initial F-16 aircraft.

The following chart shows the existing obligations, as of December 1982, made on future FMS procurements for Israel through this method.

ISRAEL CASH FLOW PAYMENT FORECAST FOR  
PROCUREMENT OF U.S. DEFENSE ARTICLES AND SERVICES

| <u>Existing cash flow obligations</u> | <u>Payments due</u>     |             |             |             |
|---------------------------------------|-------------------------|-------------|-------------|-------------|
|                                       | <u>FY83</u>             | <u>FY84</u> | <u>FY85</u> | <u>FY86</u> |
|                                       | -----(\$ millions)----- |             |             |             |
| Purchases from DOD (FMS)              | 591                     |             |             |             |
| Purchases from commercial sources     | <u>440</u>              | DELETED     |             |             |
| Total cash flow outlay                | <u>\$1,031</u>          |             |             |             |

Defense Security Assistance Agency (DSAA) monitors the cash flow concept and ensures that Israel has sufficient FMS funds to make the necessary periodic payments on its cash flow purchases. As a result of its major equipment purchases during fiscal years 1977-1979 under cash flow, Israel could not make any major equipment procurements during fiscal year 1981, because too many funds were already committed. Furthermore, as is discussed in chapter 5, we found that during 1980, funds provided for the Sinai redeployment were authorized for use to cover Israeli shortfalls in cash flow financing needs.

CONCLUSION

Although DOD officials point out that there is no U.S. commitment for future Israeli procurements due to the cash flow system, we believe it does imply a strong commitment that the Congress will finance large programs in future years for Israel. Because the use of this method of financing can limit congressional prerogatives in reviewing and authorizing FMS credit levels, we recommended in our February 1982 report on Egypt that the Secretaries of State and Defense fully disclose to the Congress the rationale and the implications of cash flow authorizations for Egypt and Israel.

DOD concurred, but indicated as in our Egypt report that a notification process in which the executive branch notifies the appropriate congressional committees before a country is authorized to use cash flow financing could include the details the Congress requires for justification.

We also recommended that the Congress amend the Arms Export Control Act to require advance notification by the executive branch when cash flow financing is to be authorized for selected countries.

DOD concurs in principle but is unsure that a change in the Arms Export Control Act is necessary to achieve the desired result. DOD stated that the Office of Management and Budget should initiate discussions with the State and Defense Department to resolve the question.

Israeli FMS drawdowns

Under an Office of Management and Budget (OMB) policy, a country must draw down proportionally on its FMS loans and grants rather than drawing down on grants prior to FMS loans. The policy applies to all recipients obtaining \$100 million or more in U.S. military assistance.

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It is to Israel's advantage to draw FMS grant funds first and guaranteed loans later and, thereby, postpone interest payments on its FMS loans. Israel previously was permitted to draw down its FMS grant funds prior to its loans and both it and Egypt did this during fiscal year 1982. This proportionally greater and earlier drawdown of FMS grants by Israel, during fiscal year 1982, will allow Israel to defer until many years later an estimated \$19 million in interest payments.

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However, due to budget delays and foreign policy considerations, both Israel and Egypt drew on FMS grants before FMS loans in fiscal year 1982.

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There appears to have been no firm policy for all FMS recipients until fiscal year 1983. The policy, when viewed solely from a budgetary aspect, should result in economic savings to the United States.

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## U.S. ENFORCEMENT OF ARMS SALES CONTROLS

A 1952 agreement between Israel and the United States provides that defense articles and services sold to Israel may be used only for certain purposes, such as internal security and legitimate self-defense. Although sanctions for substantial violation of these restrictions are imposed by section 3 of the AECA, the Act authorizes but does not require the President to determine that a substantial violation has occurred. It only requires that the President report to the Congress upon receipt of information that a violation "may have occurred." Section 3 sanctions may also be imposed if the Congress determines by joint resolution that a substantial violation has occurred.

Although the President has reported to the Congress at least four times that a violation may have occurred with respect to Israel, neither he nor the Congress has ever determined that Israel was in substantial violation in using weapons for an unauthorized purpose. If such a determination were made by the Congress, credits and guarantees to Israel would be cut off, as well as cash sales and deliveries under previous sales. If the determination were made by the President, he could certify that a termination of arms sales to Israel would have "significant adverse impact" on U.S. security. This would permit deliveries under previous arms sales contracts to continue, but still would cut off the use of FMS credits and guarantees for payment.

In March 1978, Israeli military forces crossed into southern Lebanon. The Israeli Government characterized its military operation as limited self-defense against a pattern of attacks from Lebanon carried out by Palestinians and directed against Israeli civilians. By letter dated April 5, 1978, Secretary of State Cyrus Vance reported to the Congress that "a violation of the 1952 Agreement may have occurred by reason of the Israeli operations in Lebanon." In view of a statement by the Government of Israel that it intended to comply with U.N. Security Council Resolution 425 which called for Israeli withdrawal from Lebanon, the Secretary of State said he was not recommending that the President take any further action.

In 1979, Israeli forces again crossed into Lebanon and U.S.-supplied Israeli aircraft bombed "Palestinian targets" in southern Lebanon. By letter of August 6, 1979, Secretary of State Cyrus Vance reported "that a violation of the 1952 Agreement may have occurred by reason of such actions as Israel's July 22 airstrikes and the deployment in Southern Lebanon of U.S.-supplied artillery subject to U.S. law."

Similarly, in 1981, the Secretary of State reported to Congress that a violation of the 1952 agreement may have occurred, by reason of Israel's air attack on Iraqi nuclear facilities. In the case of Israel's 1982 invasion of Lebanon, and the continued bombing of Beirut by Israel utilizing cluster

munitions, the Secretary of State again reported that a violation of the 1952 Agreement "may have occurred."

The language of the Arms Export Control Act itself is responsible chiefly for the lack of Presidential determinations of whether or not a substantial violation has occurred. Under section 3(c)(2), the President must report whenever he receives information that a violation "may have occurred." In each prior case, the President has followed this statutory language literally in reporting to the Congress. The Act does not require that he do anything more.

Under the AECA, the Congress also could have determined by joint resolution that Israel was in substantial violation of restrictions on the use of U.S.-supplied weapons. However, the Congress need not pass such a joint resolution nor has it done so.

A formal determination and reporting of a violation would implement the sanctions of the AECA. The sanctions would cut off U.S. assistance and arms sales as was the case during the previous embargo for Turkey over the Cyprus affair. However, taking such a step in Israel's case is something that administration officials and the Congress have been reluctant to do. They have pointed out that such extreme measures could cause a crisis in the relationship between the two countries.

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REVIEW AND OVERSIGHT OF  
ISRAELI PROCUREMENTS

Since 1952, Israel has operated a military procurement mission in New York City. It is in charge of procurements from the United States which accounts for 40 percent of Israel's annual defense budget. In 1981, for example, the Mission used FMS financing to purchase \$1.4 billion in U.S. defense goods--both from commercial sources and through direct FMS procurement.

The Mission informed us that it makes around 30,000 purchases per year, of which 1,000 are for direct FMS sales and 29,000 are for commercial purchases using FMS funds. We were told that about 100 purchases are for more than \$1 million while 85 percent are for less than \$5,000.

The Office of Munitions Control at the State Department issues export licenses for commercial procurements of military items. Its officials said that many items of potential Israeli procurement have been preapproved.

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DSAA also handles the Israeli program differently from other countries. With other country programs, DSAA reviews all

contracts for commercial purchases but has an exception from this policy for Israel due to the large volume of actions. For Israel, DSAA reviews all contracts of \$50,000 to \$500,000 after they are issued. All commercial contracts of \$500,000 or more using FMS assistance require prior approval of DSAA. DSAA reviews all billing invoices of \$100,000 or more and a random sample of those less than \$100,000. The billing invoices represent bills from DSAA approved purchase orders (contracts).

The arrangement was reached in 1981, whereby the Mission submits all billing invoices over \$100,000 to DSAA and promises to maintain and submit computer reports of its invoices. DSAA may randomly request any billing invoice for sample review under \$100,000. Officials at DSAA say that they review 4 to 5 sample invoices a week and that they have not found any improper purchases.

## CHAPTER 3

### ISRAEL'S ECONOMY AND U.S. ASSISTANCE

The United States has expressed its support to Israel, in addition to FMS financial assistance, through the Economic Support Fund (ESF). Besides being the largest program, ESF aid to Israel is also provided under liberal terms. The program, since 1981, has been an all grant transfer of cash provided to support the Israeli economy and help the country address its balance of payments problems.

None of the ESF aid to Israel is tied to development projects, as is the case for ESF provided to many of the other recipient countries. Therefore, the amount is not based on a specific developmental need and there is no way to measure the precise effects that these funds have on Israel's economy. Rather, these funds serve a budget support and political purpose. State Department maintains that these funds are designed to facilitate maintenance of a modest rate of economic growth and management of Israel's balance of payment problems.

In early 1982, Israeli officials sought earlier release of ESF funds than the traditional quarterly disbursement. This would enable Israel to have earlier use of the funds but at an annual cost of more than \$40 million to the U.S. Treasury for extra interest payments. Israel was advised that the United States preferred to continue with quarterly disbursements and did not renew the request in fiscal year 1983.

Israel continues to experience economic problems associated with inflation and its balance of payments. However, according to Israeli officials, it has been able to meet its debt servicing obligations, regularly increase its reserves, and expand exports. This is a considerable accomplishment given the country's large defense burden while absorbing over 1 million immigrants since its beginning as a country. These accomplishments are made possible, to a great extent, by U.S. economic and military assistance which has been a major source of funds to help the country meet its balance of payment deficit. Also, as noted in chapter 2, 37 percent of Israel's defense needs in FY 1982 were provided through FMS loans and grants.

Although U.S. assistance has been large and provided under liberal terms, U.S. decisionmakers are now faced with an increasing dilemma in continuing to bolster Israel's economy and ensure support of its budget. The flow of funds under the Security Assistance Program might, depending on economic developments, contribute to an overall increasing Israeli need for foreign currency.

Consequently, it is likely that Israel will intensify its requests to the United States for increased assistance through such ways as increased amounts of ESF, better terms on future loans, and through U.S. assistance as consumers of Israeli products.

In addition to Israel's rising military debts and other problems, the United States is faced with the possibility of indirectly supporting Israeli actions, with which it does not necessarily agree, through the bolstering of Israeli budget needs. Furthermore, the Israeli Government's liberal subsidies granted to its people for settling on the West Bank must be absorbed at the cost of other needs. Israeli officials, however, maintain for example that the Lebanon campaign will not result in any increase in requests for U.S. assistance.

It is widely recognized that the United States has a responsibility to assure that, when we provide foreign assistance and weaponry, it is utilized in manners that are consistent with overall U.S. objectives and are not detrimental to the best interests of the United States.

#### THE UNITED STATES DEVOTES SUBSTANTIAL SUPPORT TO ISRAEL'S ECONOMY

Between 1972 and 1982, the United States provided \$5.9 billion, first under the Security Supporting Assistance program and currently under ESF. According to the Agency for International Development (AID), which administers the program, these funds provide direct support to Israel's economy by assisting the country to pay for its balance of payments deficit. Further, the assistance encourages economic stability in the face of the tremendous burden caused by the large percentage of resources devoted to defense.

#### The quantity and quality of U.S. economic support

The ESF program, which authorized about \$2.5 billion<sup>1</sup> in assistance worldwide during fiscal year 1982, is second in size

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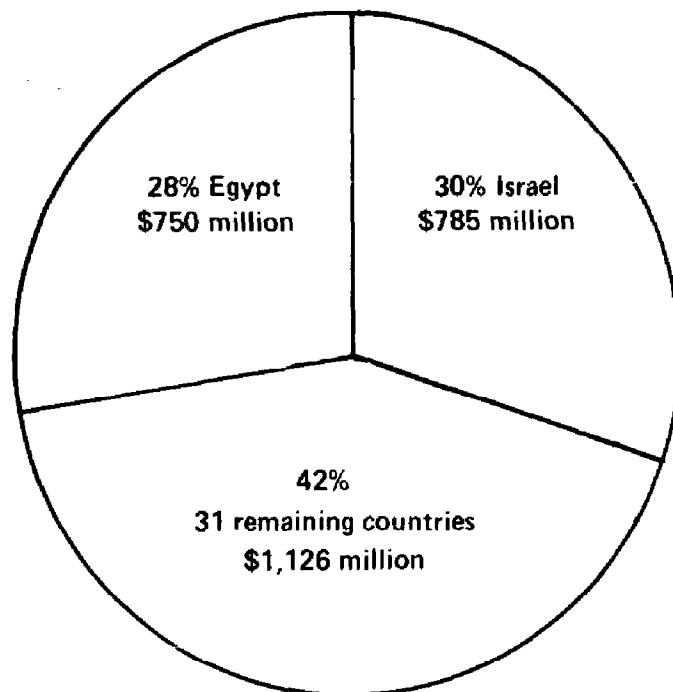
<sup>1</sup>This figure does not include \$42 million which the Congress added to Israel and Egypt (\$21 million each). These funds were allocated in fiscal year 1982 for replenishment of the \$42 million shifted from their individual programs to El Salvador and Liberia in fiscal year 1981. Israel, in fiscal year 1982, was authorized \$785 million plus the \$21 million for a total of \$806 million.



to the FMS program among the five major security assistance programs.<sup>2</sup>

As shown below, only Egypt receives funds under the ESF program approximating those received by Israel.

**FY 1983 Economic Support Fund Recipient's Share of \$2,661 Million**



Israel had been receiving a mix of ESF grants and loans until fiscal year 1981, when the Congress started authorizing all grants for the Israeli ESF program. The Congress has favored all grants since that time despite administration proposals to convert back to a mix of two-thirds grants and one-third loans. For fiscal year 1983, the Congress approved \$785 million in ESF grants to Israel. The administration request to the Congress in fiscal year 1984 will be for all grant ESF.

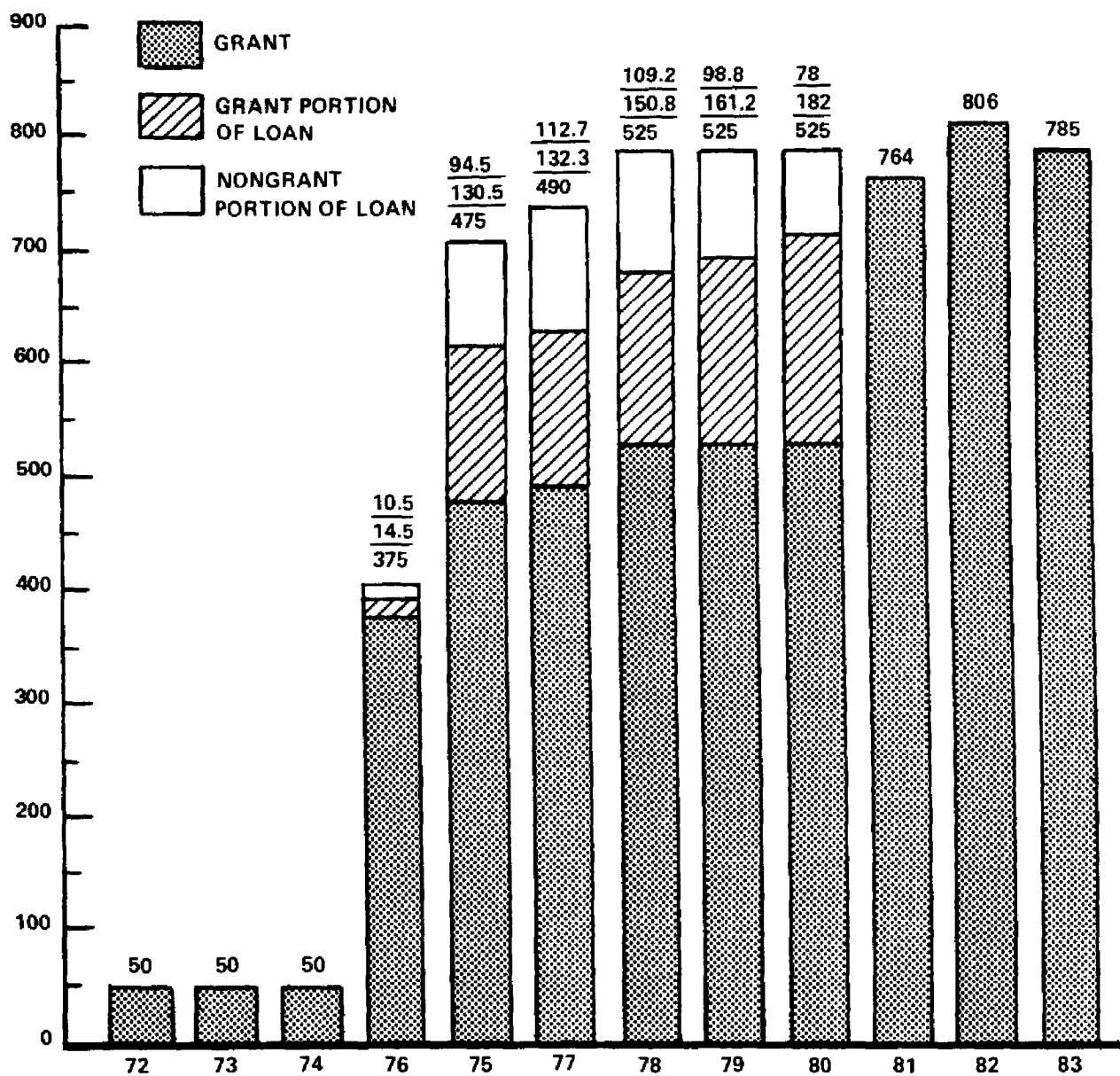
The graph on the following page depicts the levels of U.S. economic assistance since 1972.

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<sup>2</sup>The five programs are the: Foreign Military Sales, Economic Support Fund, Military Assistance Program, International Military Education and Training Program, and the Peacekeeping Operations. The FMS and ESF programs accounted for about 93 percent of all funds related to these five programs in fiscal year 1982.

**U.S. ECONOMIC ASSISTANCE FOR ISRAEL**  
(Disbursements in millions of dollars)

**FY 1972 — FY 1983**  
(note a)



<sup>a</sup>/ The loans are at a 2-3 percent interest rate with a 10-year grace period and a 30-year principal repayment term. The graph is adjusted to show the concessionality of the loans or their value in terms of a direct grant.

Israel receives this amount of economic assistance without reference to specific development projects. Many other ESF recipient countries have at least some development projects tied to assistance. This is changing, as the amounts of cash transfers is being increased.

Israel is required to purchase at least an equivalent amount in nondefense goods from the United States as the condition of receiving ESF in a form of cash transfer. Beginning in fiscal year 1979, the conditions which required that Israel provide specific evidence of each non-military purchase were dropped.<sup>3</sup> Instead, Israel was asked to ensure that (1) it will import from the United States a total amount of nondefense goods at least equal to the level of U.S. economic assistance, (2) U.S. exporters will continue to enjoy equal access to Israeli markets, and (3) it will follow procedures worked out in cooperation with the United States for bulk shipments of grain on dry bulk carriers.

#### Determination of ESF levels

Since ESF aid to Israel is not tied to specific development projects, its purpose has been expressed by the administration in various ways such as to (1) maintain economic stability and a modest level of growth, (2) provide balance of payments support, and (3) import certain civilian goods and services without high cost commercial borrowing and foreign exchange reserve draw-downs.

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<sup>3</sup>In consideration of the fact that Israel and the United States were only being burdened with cumbersome procedural requirements that did not add any control over the method with which this program had been implemented, we recommended suspension of these requirements for Israel. See "U.S. Economic Assistance for Israel (ID-78-31, Aug. 18, 1978).

Israel, in its latest aid request to the United States, requests that economic aid be granted at a volume sufficient to cover a major share of its financing gap of \$1.2 billion. The request points out that whatever Israel cannot generate from its own resources or from U.S. assistance, it must obtain through short-term borrowing. -----DELETED----- Israel could use its foreign exchange reserves or, if needed, could take further domestic austerity measures to decrease imports.

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Because ESF is not project tied, the amount of aid is based on political considerations and some economic analysis. Some observers believe that continuance of U.S. aid at the same levels as in fiscal year 1982 appeared to be the best course of action from both a political and economic point of view. According to this view this level of aid would show an undiminished U.S. support to Israel's creditors, while the aid in real terms would be lower, thus providing a possible extra incentive for Israel's economic policy makers to restrict public as well as private consumption. The same view could be applied to Israel's FY 1984 aid request. Thus, arguments against higher aid levels would be more compelling than reasons in favor of greater assistance.

First, Israel could manage at current assistance levels. Secondly, increased aid would remove some of the urgency that exists for an economic austerity program. According to this view any reduction of ESF would be impractical both economically and politically. Economically, Israel's economic stabilization programs would be damaged and it would hurt the country's chances to obtain foreign exchange from commercial sources. Politically such an unprecedented occurrence could be interpreted as a reduction in overall U.S. support, may adversely impact future peace efforts, and could affect broader U.S. goals in the entire region.

The Congress has had much impact on ESF aid to Israel by revising the administration's proposals. Based on AID's analysis of the state of the Israeli economy and debt repayment, the administration proposed that ESF be provided on a one-third loan and two-thirds grant basis for fiscal years 1981 and 1982. On both occasions, the Congress disagreed and provided the funds as a full grant. In the proposal for fiscal year 1983, the administration again recommended that ESF be provided at the same ratio of loan and grant as was previously proposed but the Congress approved a full grant. For fiscal year 1984, the administration has recommended \$785 million in ESF grants while the Congress is considering \$850 million in ESF grants.

It was proposed in the Senate to link ESF levels to Israel's annual debt repayment to the United States which is estimated to be \$722 million in 1982 and growing. Almost all of this debt is related to prior military purchases and opponents of the linkage concept fear that this might serve only to increase military loan requests. In defeating this proposal, others pointed to the precedent setting nature of such actions which might cause other countries to seek similar arrangements. The Department of State felt that such a tie could result in the diversion of funds under the total authorization from other countries which have justifiable needs.

#### Israel sought early release of funds

Traditionally, Israel has received ESF in quarterly cash transfers from AID. These funds become part of Israel's foreign exchange and can be spent without identity as U.S. aid. Last year Israel requested that all of the funds be disbursed at the beginning of the fiscal year rather than at the beginning of each quarter. Although early release of ESF funds is only done for Turkey, and this is a special case per a U.S. understanding with other donor countries, Israel's request has been supported by the House Appropriations Committee. It was granted partially when the United States released the last quarterly disbursement ahead of schedule. There was no formal request for early disbursement of ESF funds for 1983 and none was made. If ESF funds were released earlier, it would increase the interest costs for the United States because the U.S. Treasury would have to borrow the funds earlier. At the same time, releasing ESF earlier would be a corresponding benefit to Israel.

To ascertain the significance of this extra cost to the United States, we calculated the amount of interest that would have been involved for fiscal years 1981 and 1982, using interest rates provided by the Treasury Department. In fiscal year 1981, the ESF for Israel was \$764 million and the additional interest charge to release these funds at the beginning of the fiscal year would have amounted to \$46.3 million. In fiscal year 1982, the ESF amount was \$806 million and the corresponding additional cost of early release would have been \$41.5 million. Although a smaller amount of ESF was distributed to Israel during fiscal year 1981 than in 1982, the greater amount of interest reflects the higher market rates of interest charged during that year.

#### CONCLUSION

The costs to the U.S. Treasury for the earlier release of funds would be substantial. If AID, as the program administrator, or the Department of State, as the policy maker, agrees to release ESF funds earlier than on the traditional quarterly basis for any country, this should be done only with the full recognition of the extra cost to the United States.

#### ISRAEL'S PROBLEMS AND PLANS RELATED TO ECONOMIC DEVELOPMENT

In Israel's fiscal year 1982,<sup>4</sup> defense and debt alignment expenditures were estimated to be about 57 percent of its total budget. Its defense spending equated to an estimated 21.3 percent of its Gross National Product (GNP).

It is important to point out, however, that about one-third of Israel's defense budget from 1977 to 1981, was funded by the United States, mostly through FMS grants and loans. The grants have no adverse impact on the Israeli economy while the loans have a 30-year term with a 10-year grace period on principal. Therefore, Israel, in effect, has been able to defer paying a large portion of its defense budget each year.

An Israeli official noted that, due to U.S. aid, Israel has been able to meet its debt servicing obligations without fail, regularly increase its foreign reserves, and has expanded exports. Without U.S. aid, it is doubtful that Israel could have accomplished this given its tremendous defense requirements. However, Israel's foreign reserve position, although growing in absolute terms, is declining as compared to its level of imports. In 1981, the reserves were sufficient to finance only 11 weeks of imports as compared to 16 weeks in 1973,

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<sup>4</sup>Began April 1982.

according to Israeli statistics. -----DELETED-----  
Along with U.S. aid, Israel points to its reserve position as a major factor enabling it to borrow funds on the commercial market.

### Israel's economic goals

Israel has an immediate goal to reduce the rate of its inflation (132 percent in 1982) and a longer term goal to effect a gradual decline in the current account deficit of the non-military balance of payments, which includes interest charges on military and nonmilitary debt. However, Israel estimates that military imports will rise so that its overall current deficit will not be reduced during its forecasting period through 1986. According to Israel's current aid request to the United States:

"Economic policy in the coming years will be based on the concept of controlled and selective growth. The target is to stimulate the economy up to the level at which inflationary pressures can be kept under control. Growth will be led by an optimal increase in exports and a renewed upswing in investment, while the increase of private and public consumption will be restricted."

According to an Israeli Government official, the causes of these economic problems are the increased prices of oil, grain, and other imported products, the country's domestic growth and, of course, its very high military expenditures. Israel has been virtually operating in a wartime economy since its establishment as a state in 1948. Twenty percent of its work force is directly and indirectly employed by the military or in defense related industries. Of these, many are needed for service in Lebanon, the West Bank, Gaza and the Golan Heights.

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Israel's rate of inflation has been more than that common in other industrial countries. In 1980, annual inflation was 132.9 percent, the highest in the world that year, dropping to 101.5 percent during 1981, and was about 132 percent during 1982. Israel has shielded its population from the effects of inflation through an indexing system that adjusts costs and payments to help keep pace, and subsidies to keep prices on certain basic commodities, artificially low.

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At the same time, Israel's strong unions have been able to extract real wage gains, thereby increasing demand for both domestic and imported products. An increase in the domestic

demand can prompt Israeli manufacturers to produce to satisfy these demands rather than producing for the export market. There is some disagreement as to the extent to which this last phenomenon is occurring at present.

In order to reach its longer term goal of continued reductions in its non-military balance of payments deficit, Israel seeks to improve export growth.

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Historically, Israel has been very successful in this endeavor and, although it continues to experience a trade deficit, the rate of exports has increased faster than imports. As a result, the proportion of non-military imports financed by exports grew from 68 percent in 1973 to 84 percent in 1981. Viewed another way, Israel's non-military trade deficit was about 47 percent of exports in 1973 as compared to about 20 percent of exports in 1981.

Israel projects that, if it can implement its policies and if the world economy turns upwards, it will be able to increase annual exports by about 15.5 percent, realize an annual real GNP growth of about 5 percent, and increase real gross domestic investment growth by 7 percent. By sustaining such growth, Israel points to a projected net decline in its non-military balance of payments deficit from an estimated \$2.7 billion in 1982 to \$1.6 billion by 1986, a 44 percent reduction.

Overall, however, according to Israel's own figures, almost all of the reductions projected to occur in its non-military deficit will be offset by increases in the country's direct military imports so that little change will occur in the overall deficit. Israel's published economic policies do not address this critical factor. An example of the problem is that according to Israeli officials, budget cuts were planned in the defense sector in fiscal year 1982, but because of the need for supplementary budgets due to the war in Lebanon, these cuts will not be realized.

#### U.S. assessments of Israeli goals

U.S. assessments cast doubt on Israel's ability to reach its economic goals as quickly as it anticipates.

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Some observers have proposed a determined U.S. effort to help Israel increase its exports as a way of eventually reducing aid levels. Since the United States has already taken some initial steps in the area of military exports (see ch.4), they recommended an examination of similar possibilities for civilian exports. Both countries obviously prefer to lessen Israel's dependence on direct U.S. assistance in return for an economically stronger Israel. However, for Israel to become more independent of U.S. aid, it will probably require that the United States consume more Israeli goods which is a degree of dependence in itself.

There are also limitations on Israel to realize substantial changes domestically. For example, one source pointed out that Israel is unable to significantly reduce defense expenditures or debt repayment which account for almost two-thirds of total government expenditures. The prospects for achievements in reducing private consumption do not appear appreciably better especially in light of Israeli insistence that indexation cannot be abolished and its seeming inability to restrict wage increases. Israel believes that substantial austerity measures could tempt emigration from Israel and promote labor unrest. Unless international conditions signal growth prospects, significant new investment is not likely to take place. Too many Israeli assumptions depend on circumstances either outside Israel's ability to control (i.e., world economic recovery) or beyond the bounds which Israeli democracy imposes on measures restricting private consumption.

#### ISRAELI DEBT SERVICING REQUIREMENTS FOR DEFENSE PURCHASES

In fiscal year 1982, Israel paid \$722 million for defense loans to the United States. Although ESF is not intended to service FMS debt, in theory, the amounts have been such that Israel has been able to cover its U.S. military debt repayments with cash transfers under the ESF program.

Israeli military debt repayment will rise from a projected \$887 million in fiscal year 1983, to about \$1.1 billion in fiscal year 1992. In a earlier report<sup>5</sup> we found that for the next several years, Israel appears likely to be able to repay its FMS obligations (mostly interest) but could encounter debt servicing problems when it also begins to pay large principal payments after the expiration of its grace periods. Principal payments will continue to mount as the grace period for each succeeding year's program expires. In 1983, Israel's FMS debt is projected to be 84 percent of its total debt to the United States. The sheer size of Israel's FMS loan payments (projected to be over \$900 million annually) combined with factors affecting its balance of payments prospects could alter Israel's ability to service its debts. Such factors were identified by AID in its 1982 report on Israel's economy and debt repayment prospects as

- the price of imported energy,
- economic conditions in the countries with which Israel trades,
- political and military developments in the Middle East and their impact on Israel's defense spending, and
- the rate and pattern of growth in the Israeli economy.

As noted earlier, even with a general recovery of the world market for exports, it would appear doubtful that Israel can realize its optimistic forecast for export growth to help pay for this rising debt burden. If Israel were to use its foreign exchange reserves, its credit rating in the international commercial market could be adversely affected and, if it increased commercial borrowing, it would only shift the debt from the U.S. Government to the commercial market which has shorter repayment periods and higher interest terms which would heighten the overall debt in later years. Thus, Israel is more likely to make further requests that the United States assist by increasing its economic support.

Other options for Israel include seeking more concessional loans, a greater amount of forgiveness in its FMS loan program, or further expansion of the grace period for FMS loans. Israel has already asked that the United States revert back to the one-half forgiven credits and one-half loan formula for FMS aid as was done prior to fiscal year 1981. These steps, of course, would result in additional costs to the United States.

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<sup>5</sup>"Unrealistic Use of Loans to Support Foreign Military Sales" (GAO/ID-83-5 Jan. 19, 1983).

Since there is a political linkage between aid to Israel and Egypt, the Congress would also have to consider the double budgetary impact of such a step. Although the Congress could decide to increase ESF to fully cover the debt servicing requirements as has been proposed, opponents of such a proposal point out that Israel would thus avoid incurring the financial discipline of repaying FMS loans that calls for prudence in its spending. Furthermore, this could also set a precedent for other countries to request the same treatment. The administration has opposed the idea of indexing economic assistance to military debt repayment because of the lack of budgetary control implied in such a principle and the precedents it would set.

If the United States were to forgive more of the loans, it would have a direct effect on increasing the U.S. budget. This is because the FMS guaranteed loans are currently off budget and therefore excluded from the need for additional budget authority and are financed through the Federal Financing Bank. We have previously reported on how this circumstance can affect the make up of an assistance program.

In a 1977 report to the Congress,<sup>6</sup> we stated that unwarranted growth of off-budget guarantees provided the potential for a poorly designed assistance program because there was potential for increased use of full guarantees where partial guarantees or more direct forms of Federal assistance are more appropriate. In a later report<sup>7</sup> to the Congress, we reaffirmed this view and we also pointed out that, although it appeared likely that Israel would be able to repay current FMS obligations (mostly interest), it could encounter debt service problems when the 10-year grace periods expire and when it also begins to pay large principal payments.

A 1982 U.S. study on the overall balance of payments problem and debt servicing situation drew similar conclusions. The study included a projection of all debt repayment; military imports in excess of U.S. military assistance; and civilian imports over exports. Given current financial policies, it concluded that

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<sup>6</sup>"Government Agency Transactions With The Federal Financing Bank Should Be Included On The Budget" (PAD-77-70, Aug. 3, 1977).

<sup>7</sup>"Unrealistic Use Of Loans To Support Foreign Military Sales" (GAO/ID-83-5 Jan. 19, 1983).

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Agency Comments

The State Department commented that they do not foresee the development of a severe debt situation. AID reported that it is not at all evident that there will be a deterioration in Israel's balance of payments. It noted that there is cause for optimism about Israel's balance of payment prospects and that it appears unlikely that Israel will need to devote any greater percentage of its foreign exchange earnings for debt repayment during the next several years than it did in 1982. AID went further to report that it may be more likely that the debt service burden will be reduced. The State Department commented that although it is true that Israel faces a level of debt service obligations which obligates prudent financial management and planning there is no reason to doubt that Israel can undertake such measures.

Nonetheless it would appear that the United States may face greater pressure regarding the amounts of aid to Israel and the conditions with which it is granted.

ECONOMIC IMPACT OF THE LEBANON CRISIS

According to Israeli officials, the Lebanon campaign will not result in any increase in aid requested from the United States.

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Israel divides the costs associated with the Lebanon campaign into two categories--direct and indirect--which are to be funded over a 3-year period. Direct costs include the loss, damage to, and amortization of equipment; the maintenance of reservists; and public works and transportation related to the operation. Direct costs are divided by Israel into those which can be financed domestically and those which require foreign exchange (i.e., imported goods). The indirect costs are

measured in terms of the loss of production. According to preliminary information provided by Israel, the costs are estimated as follows:

|                            | (in millions)  |
|----------------------------|----------------|
| Direct Costs               | \$1,000        |
| Domestic component         | \$650          |
| Foreign exchange component | 350            |
| Indirect Costs             | <u>200</u>     |
| Total                      | <u>\$1,200</u> |

The \$650 million direct costs are to be financed domestically over a 3-year period from budgetary cuts, an increase in the value-added tax (from 12 to 15 percent), the imposition of a 3-percent import levy, a compulsory loan from wage earners and companies, and a tax on stock market transactions. In its current aid request, the Government of Israel has indicated that it would like to use larger amounts of FMS for domestic defense-related purchases than it had previously projected. It is possible that this increase is to cover war-related expenditures. On the other hand, the increase may result from other considerations, such as inflation or a shift in the types of items which Israel plans to produce domestically.

The remaining 35 percent, or \$350 million, represents the foreign exchange component of the direct costs which are to be financed over the next 3 years, half from private sources abroad (bond sales and the United Jewish Appeal) and half from commercial borrowing.

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The estimated \$200 million in indirect costs does not include substantial tourism losses. These losses began prior to the Lebanon campaign and for the most part can be attributable to the international economic situation. For example, in June 1982, there were 22 percent fewer tourists than the year before. Using this as a basis, Israel's estimated loss in foreign revenues would be about \$100 million during its fiscal year 1982. Inclusion of this component would increase Israel's total foreign exchange needs associated with the campaign to approximately \$475 million (the \$350 million plus the \$100 million and another \$25 million which Israel had already included under indirect costs for loss of exports).

## CHAPTER 4

### U.S.-ISRAELI COOPERATIVE EFFORTS IN DEFENSE INDUSTRIAL DEVELOPMENT AND TRADE

Israel is heavily dependent on U.S. financial and technical support to achieve its own arms production capability. In an effort to promote greater self-reliance, it seeks further U.S. help to assist in developing its defense industries and expand its trade opportunities.

DOD believes and we concur that FMS was intended for purchase of goods and services in the United States to support U.S. firms. Israel has already been granted, and continues to request additional liberalized methods and amounts of assistance beyond that of any other FMS recipient country. Among these are that Israel:

- receives trade offset arrangements from U.S. firms when it makes FMS purchases. Offsets are commitments by U.S. firms to purchase a specified amount of Israeli goods or services. Such arrangements are common under commercial arms sales but unusual under FMS. These arrangements are not encouraged by the U.S. Government nor does it attempt to hinder or control them.
- has asked that it be allowed to use FMS credits to purchase its own products as an integral part of the U.S. security assistance program;
- has asked that other countries be allowed to use their FMS credits to purchase Israeli goods;
- has asked that the sale of Israeli goods to U.S. armed forces be promoted and allowed without the usual restrictions placed on other countries' products;
- has asked to be allowed to use FMS credits to purchase tooling and production equipment from Israeli sources in order to build up its production capabilities; and
- has asked that the United States provide the necessary technology and funding for Israel to produce its own highly sophisticated aircraft.

Development of industrial self-sufficiency, in itself, is certainly a worthwhile goal in that less direct U.S. assistance

should be needed over the longer term. However, the impact on the U.S. economy and employment situation, and the U.S. ability to control the sales of advanced weapon technology should be considered in providing the concessions requested by Israel.

It is recognized that Israel is not currently considered a significant competitor in the international arms market but it is rapidly increasing its sales; for example to Latin America. However, if Israeli industry and trade are eventually expanded to a point where direct U.S. assistance can be greatly decreased, the Israeli competitor factor in the international arms market will also have increased. Moreover, and possibly the most important factor for U.S. decisionmakers to consider, is the extent that the liberalized steps might be setting a costly precedent. Other FMS countries such as Korea, and Egypt will most likely ask for the same. If these are granted, it will compound the long range impact on the United States.

#### U.S. COMMITMENTS AND EFFORTS TO SUPPORT ISRAEL'S DEFENSE INDUSTRY AND TRADE

One day prior to the outbreak of the 1967 Six Day War, France placed an embargo on military equipment to Israel and it was thus spurred to become more militarily independent and to invest heavily into its defense industries. Since that time, Israel has received U.S. financial and technical support to help achieve its own arms production capability. Through domestic arms production, Israel strives to meet its own defense needs as independently as possible and maintain its qualitative edge over Arab weaponry. Nonetheless, Israel will probably remain dependent on the United States for the most advanced and sophisticated military equipment and aircraft. The massive investment in research and development required for such equipment requires economies of scale that Israel is unlikely to be able to achieve.

A Master Defense Development Data Exchange Agreement with the United States (December 22, 1970) permits and facilitates the exchange of information important to the development of a full range of military systems including tanks, surveillance equipment, electronic warfare, air-to-air and air-to-surface weapons, and engineering. As of August 1982, 25 separate data exchange annexes, which cover individual projects under the agreement, had been concluded.

Israel's technological exports are heavily dependent on foreign components. Israeli officials estimate that during 1981-1982, most of their exports contained an import component of about 36 percent. In Israel's fastest growing industry, the electronics field, about 35 percent of the technical expertise

is acquired from the United States in licensed production or technology transfer. Almost every Israeli arms production effort includes a U.S. input, as shown in the following table:

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According to a State Department official, the United States has permitted Israel to coproduce U.S. defense equipment through licensed production at a "higher level of technology" than it has any other FMS credit recipient. Part of the reason is that Israel is probably more industrialized than the other recipient countries and it has sufficient levels of FMS credits to afford high technology coproduction.

Major U.S.-Israeli defense trade agreements

March 19, 1979, Memorandum of Agreement (MOA) provides competitive opportunities for Israeli industry to compete in the DOD procurement market. It permits Israeli firms to bid on certain U.S. defense contracts without Buy American Act restrictions, and facilitates cooperation in research and development.

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The original MOA continues to provide opportunities for Israel's industries to competitively bid on DOD contracts.



## Memorandum of Agreement

The MOA is a major U.S. commitment to stimulate various types of cooperation in research and development (R&D) and procurement and logistics support of selected defense equipment. The MOA has two annexes: Annex A which provides for three areas of cooperation in research and development. Annex B seeks to promote reciprocal defense procurement.

### Annex A

Annex A expanded the existing Data Exchange Program and provided for cooperative R&D programs. These include joint R&D; supporting R&D (one country's contractor performs R&D for the other country); equipment evaluation toward potential procurement; and competitive R&D (one country's contractor competes against the other country's contractors in bidding on contract awards). The third aspect of this annex is a Scientist and Engineer Exchange Program. This has included a tour of one U.S. scientist to Israel in 1980, one in 1982, and two Israeli scientists to the United States.

### Annex B

Annex B provides an open-end list of over 610 military items and services on which Israeli firms can submit competitive bids on DOD requirements without application of Buy America restrictions, similar to the lifting of such restrictions for our NATO partners. The list was expanded from its initial 500 items and can be further enlarged. DOD can thus waive the Buy American Act with respect to Israeli products in awarding contracts for such items as parts for the M-60 and M-1 tanks; missile components; aircraft and aircraft components; and ammunition, bombs, grenades, and fuses. U.S. firms have not fully exercised the reciprocity clause to bid on Israeli products under this agreement. Information on the level of procurement activity occurring under the MOA varies because the United States and Israel differ on what should be included. Israeli officials say that Israel is conducting about \$10-\$15 million per year in business under Annex B, excluding a more recent \$39 million contract for radios. However, Israel's figures do not include offsets or subcontracting arrangements with U.S. contractors for its major equipment purchases.

DOD has not had a formal reporting system to track subcontractor awards. Precise data is unavailable because Israeli firms often participate as subcontractors with U.S. firms and because procurement is decentralized. For example, there

are numerous contracts of U.S. European commands which involve Israeli firms. One DOD official, familiar with the U.S.-Israel 1979 MOA estimates that, from 1979 through 1982, Israeli firms sold DOD and DOD contractors approximately \$75 million worth of goods under the MOA. A partial list of procurement activities under the MOA (as of mid-1982) provided to us by DOD is as follows:

- DOD contract to Israel for overhaul of F-4 components (\$1.7 million).
- United States purchased from Israel three mine plows for evaluations (for \$190,000).
- United States leased from Israel six 105mm guns and purchased ammunition for evaluation. Further service evaluation is expected with possible buy thereafter (value unknown).
- Israeli firm won competition (joint effort) with McDonnell Douglas to sell B-300 assault weapon to U.S. Marine Corps (\$11 million for fiscal year 1982, total contract value \$300 million).
- Israeli firm won competition to produce AN/VRC-12 radios (\$39 million).<sup>1</sup>
- Israeli firm sold 9mm ammunition (\$970,000).
- Israel sold tank parts for U.S. Army and FMS use (\$5 million).
- Israeli firm sold pharmaceuticals to Defense Logistics Agency (value unknown).
- Israel provided ground support equipment for U.S. Air Force test. United States buy possible thereafter (\$79,000).
- Israeli firm sold conformal fuel tanks for F-15 to McDonnell Douglas (\$3.1 million).
- Israeli firm sold USAF F-4 fuel tanks (\$2.4 million).
- Israeli firm sold USN A-4 fuel tanks (\$2.0 million).

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<sup>1</sup>This was protested to GAO's Office General Counsel, GAO denied the protest. (E-Systems, Inc., B-206209, June 4, 1982, 82-1 CPD 533.)

Defense Trade Initiative

After Israel extended its law, jurisdiction and administration into the Golan Heights in December 1981, the United States informed Israel it would not be able to proceed with the 1981 MOU and the Defense Trade Initiative.

One element of the Defense Trade Initiative was a DOD/State effort to help stimulate Israel's defense industries through exports and through DOD procurement of up to \$200 million in Israeli-produced equipment. It was hoped that these initiatives would ease the heavy Israeli defense burden and, ultimately, the U.S. aid burden; reduce the adverse economic effects on Israel of costly military imports; and promote both short-term improvements and long-term modernization of its defense industry.

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An interagency Defense Trade Task Force was established in April 1981 to implement this commitment. The Task Force sought methods for stimulating Israel's industry within existing budgetary and security assistance funding levels. It also attempted to determine market areas in which to encourage development and tried to encourage more efforts on the part of Israel's defense industries.

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Despite the non-implementation of the 1981 MOU, some activities covered by the Defense Trade Initiative can continue under the 1979 MOA. For example, the list of items for potential DOD procurement in Annex B was expanded and procurement activities continue.

Israel hopes the freeze on the Defense Trade Initiatives will soon be rescinded. In its 1984 aid request, it asked for assistance to promote Israeli exports of goods and services to the United States at an annual level of \$200 million as an intermediate goal. If the United States approves the request, it would assist Israel to achieve its ambitious export growth targets.

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Israel wants the United States to: formally encourage major U.S. military equipment exporters to conclude buy-back arrangements with Israeli manufacturers; encourage DOD contractors to involve Israeli manufacturers as subcontractors; exercise a liberal policy with regard to reciprocal transfers of advanced technologies; and assist in the modernization of Israeli industry. Further, Israel requests permission to provide maintenance and refurbishing services to U.S. forces stationed overseas. In addition, Israel asks for further expansion of the MOA list to include non-military items, as well as facilitating such sales to the United States.

#### ISRAEL'S DEFENSE INDUSTRY EXPORTS

A large part of Israel's resources are devoted to building and maintaining its defense industry. Because of the relatively short production runs on major items of military equipment, Israel pursues an aggressive export program to help offset the large capital investments and high overhead involved in the production process.

Israel's world exports of military equipment reached --- in 1981 (up from --- in 1977). Small arms, ammunition, communications and electronics, as well as obsolete military equipment, constitute the bulk of the exports. Sales of major military equipment, however, account for an increasing portion of the total.

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Sales include transport aircraft; patrol boats, antiship missiles; air-to-air missiles; and substantial quantities of automatic weapons. In addition, Israel has sold --- Kfir fighter aircraft for an estimated --DELETED-- to Ecuador after receiving U.S. approval for third country export of the U.S. engine used in the airplane. The market for potential sales could be as high as --DELETED-- to other Latin American countries for Israeli produced aircraft if U.S. approval is provided.

In commenting on Israel's exports, a September 1982 U.S. report said:

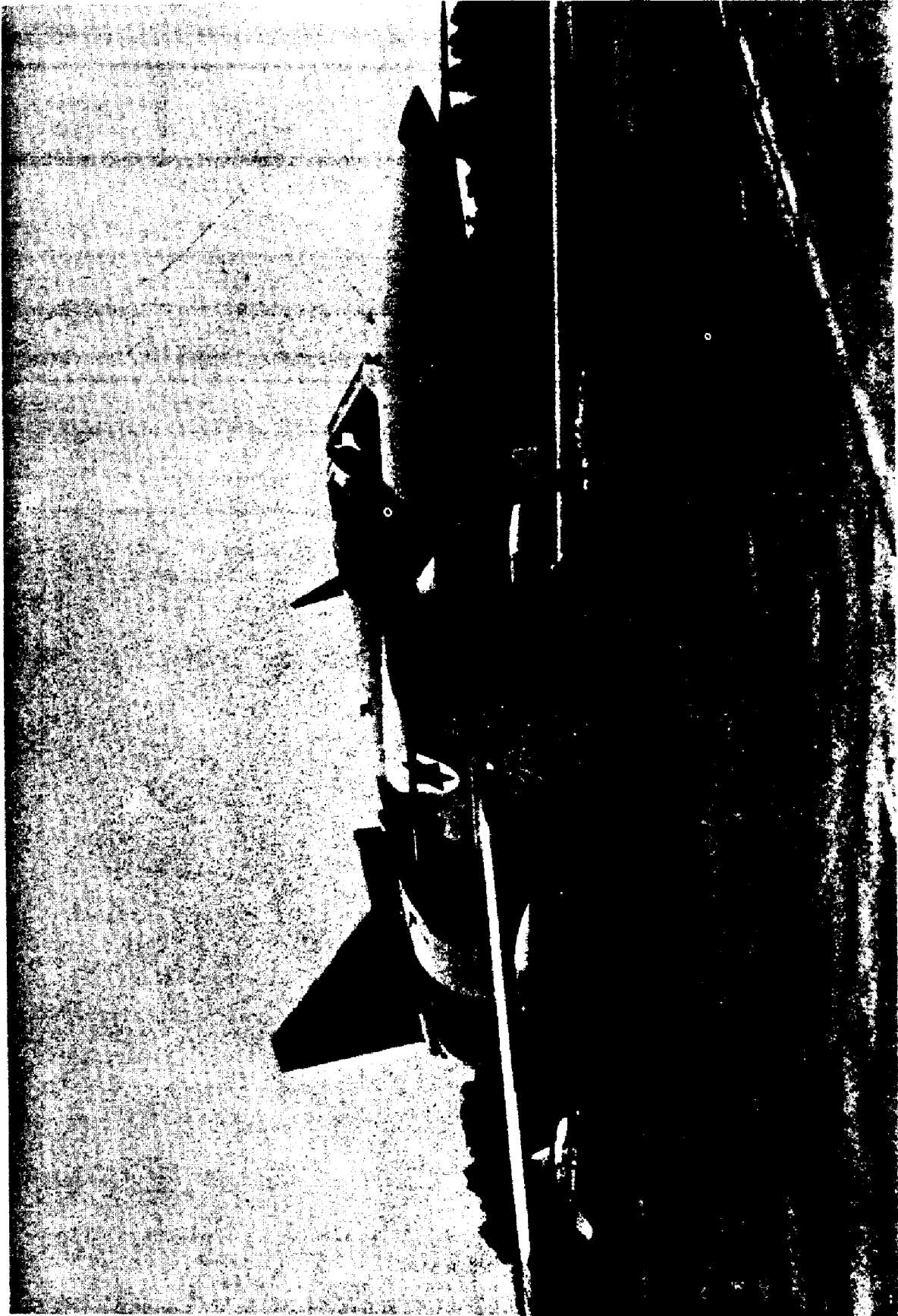
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ENCOURAGING ISRAEL'S ARMS INDUSTRY DEVELOPMENT  
AND TRADE THROUGH LIBERAL USES OF FMS CREDITS

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While such uses of FMS credits would assist Israel's industrial base and trade, a question arises as to precedents set for other FMS credit recipients. In the long term, the question becomes what is the impact of such trends on the U.S. industrial base and U.S. employment.

**UNCLASSIFIED**



Source: Israeli Aircraft Industry

Israeli Combat Fighter "KFIR C-2"

Requests for liberal allowances  
for offshore procurements

Israel is seeking to be allowed to purchase its own goods with FMS credits and to allow other recipients to use their FMS credits to make purchases in Israel as an integral part of its U.S. security assistance program. Normally FMS credits are used for purchases in the United States. Israeli officials told us that they need \$150-\$200 million a year in FMS to purchase their own goods, which, since they are outside the United States, are called offshore procurement. In its 1984 aid request, Israel asked that \$200 million in FMS assistance be used for DOD procurements from its industry.

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Israeli officials told us that requests for using FMS funds for in-country production are made only if that particular item meets the following criteria:

- a high priority item which will meet a specific Israeli defense need;
- will not compete for export sales with U.S. products; and
- only limited numbers are to be produced in Israel.

Between June 1981 and June 1982, Israel proposed that it be allowed to use its FMS credits for purchases from its own industry and that other recipient countries be allowed to purchase Israeli goods with their FMS credits. For example:

--In-country production with Israeli FMS credits

Merkava tank  
Shafrir air-to-air missiles  
Fire control systems for tanks

Lavi fighter development

--Sales to other recipient countries for their FMS credits

Dabur patrol boats  
Fouga Magister aircraft  
Mini remote piloted vehicles  
Radar systems

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Conclusions

If any FMS recipient country is granted approval to purchase its own goods as an integral part of the program or other recipient countries are allowed to use their FMS credits to purchase goods in that country it could be used as a precedent for other recipients and cause an adverse impact on the U.S. economy.

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Offsets: A different use of FMS assistance

The Israeli Government has a policy of requesting U.S. suppliers to offset or "buy back" from Israel goods or services equal to 25 percent of Israeli purchases of \$1 million or more. Israeli officials said that this is to help offset Israel's



rapidly increasing military debt repayment burden. However, DOD reported that this has the possibility of adversely affecting U.S. companies and subcontractors since the FMS funds designated for the particular project will not be actually spent in the United States.

The Israeli Defense Mission informed us that although this offset request has been a long term Israeli policy, it views its success as very limited. We do not know the extent that offsets actually occur. DOD does not review or track such arrangements because it believes they are private arrangements between U.S. and Israeli firms.

Offsets can take the form of an arrangement where a military sale vendor promises to purchase related or unrelated goods and services from the buyer's country. These are termed indirect offsets. Offsets can also take the form of coproduction or subcontracting, where the vendor agrees to subcontract production of components or subsystems of a weapon system sale to a firm in the purchasing country. These arrangements are called direct offsets.

The use of offsets by vendors as an inducement to obtain defense sales has become more widespread and many foreign purchasers now expect to receive them as a matter of course. Offsets are ordinarily made by countries using their own funds to purchase arms without U.S. FMS assistance. More unusual are offset arrangements for procurements made with FMS credits. The Departments of State and Defense commented that the administration believes these funds were intended by the Arms Export Control Act, for the purchase of materials and services in the United States.

The Aerospace Industries Association of America and the Electronics Industries Association, conducted a survey of offset arrangements in contracts signed between 1975 and 1981. The survey, involving responses from 26 large U.S. aerospace and electronics equipment manufacturers, identified 23 countries with offset arrangements. Only four of these countries were FMS credit recipients as follows:

FMS CREDIT RECIPIENTS  
WITH OFFSET ARRANGEMENTS

| <u>Recipient</u> | <u>Value of</u><br><u>offsets</u><br>(\$ thousands) | <u>Number of</u><br><u>contracts</u> |
|------------------|---|--------------------------------------|
| Israel           | 262,250   | 12                                   |
| Spain            | 32,400  | 5                                    |
| Korea            | 5,000   | 1                                    |
| Greece           | 910   | 1                                    |

We did not determine whether the offset agreements with Spain, Korea, and Greece were related to purchases with FMS credits. However, the survey results indicate that Israeli offsets from U.S. defense suppliers greatly exceed that of the other identified FMS credit recipients.

According to Israeli officials at the New York Mission, requesting 25 percent offsets is a long standing policy. They said that, at any given time, some \$500 million in long term offset commitments from U.S. defense contractors to Israel are outstanding, but only about 10 percent of these offset commitments are successfully implemented. Since the U.S. Government does not track offset agreements, we were unable to determine the total value of offset agreements related to procurements with FMS credits.

Indirect offset commitments generally are not firm contract commitments of purchases. Instead, the U.S. supplier agrees to use its "best efforts" to achieve certain dollar goals of purchases of Israeli goods over a specified timeframe. For example, Israeli officials explained that McDonnell Douglas, in its F-15 aircraft sale to Israel, agreed to use "best efforts" to purchase \$100 million of Israeli goods over a 10-year period. According to Israeli officials, while U.S. companies may sign best effort contracts, they do not always achieve the commitments.

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Direct offsets are those cases in which Israel asks that certain components or subsystems of a weapon system, which it is buying from a U.S. supplier, be produced in Israel. For example, as a direct offset for Israel's first F-16 aircraft purchase, an Israeli firm is producing the F-16 aircraft's composite rudder.

Often it is not economically viable for Israel to set up a capability to produce components only for its own procurement of a U.S. end item. Israeli officials told us that U.S. suppliers and the U.S. Government have to be willing to accept Israel as a long-term source of supply. Only then does a proposition become economically feasible for Israel to undertake.

Israel is willing to become price competitive and obtain approval from the responsible U.S. military service for the manufacture within Israel of weapons system components for use by Israeli and U.S. forces. Israeli officials state that most Israeli firms are sufficiently competitive but it cannot do a large amount of business in direct offsets because U.S. industry is reluctant to depend on foreign sources for components.

According to Israeli officials, offset arrangements help soften the impact of massive U.S. assistance/loans on Israel's economy and reduce Israel's debt burden. These officials take the position that, since much of Israel's military aid is in the form of loans which it must pay back with interest to the United States, it needs offsets to reduce their impact. They also say that most of the offsets come back to the United States in additional Israeli purchases of raw materials and other goods. Finally, according to these officials, offsets support the long-range goal of cutting Israel's dependence on the United States and help Israel out of the "vicious cycle of borrowing to pay off debts." They acknowledge, however, that the United States could expect no change in aid levels for the short term--and that they could not estimate the amount of time that would be needed to achieve the longer term goal of self-sufficiency.

#### THE HIGH PRICE FOR ISRAEL'S LAVI FIGHTER PROGRAM

In February 1982, Israel officially decided to go forward with another indigenous aircraft fighter development program--the Lavi. Israel considers this costly program of great national importance to its high technology industrial base and military independence. However, Israel will be significantly dependent on U.S. technology and financing for major portions of the aircraft. Israel will also require U.S. approval for the planned third-country sales because of the U.S. engine and the significant amount of U.S. origin high technology used in the Lavi's airframe construction, avionics, and planned weapons systems. It is expected that the Lavi will be competitive with U.S. and European fighter aircraft now in production and those planned for the 1990s.

The Lavi was originally intended, in 1979, to be a low cost, low technology, clear air-mass, primary ground support aircraft to replace Israel's aging A-4 and Kfir aircraft. At that time, the United States supported the program in principle, and was willing to permit Israel to use it FMS credits to buy U.S. components for Lavi development. Subsequently, the Lavi's design and performance characteristics and envisioned level of technology were changed to make it more than an A-4 replacement. The United States is considering the question of assistance in its further development.

Israel continues in its intent to build the Lavi and to seek large-scale U.S. financial and technical assistance for development and production. By July 1982, Israel requested authorization to obligate nearly \$200 million in FMS credits for expenditure in Israel on the Lavi. In April 1983, the administration decided to approve license requests for Phase I

of the wing and tail design (composite construction) and release production technology licenses for the servo actuators and flight control computer. Requests concerning funding assistance for R&D and production in Israel have not been received but will be addressed on a case-by-case basis. The Government of Israel insists that it intends to proceed with construction of the Lavi whether or not U.S. financial or technical assistance is forthcoming.

### Evolution of a high technology airplane

Based on discussions with U.S. industry representatives the Lavi program concept began in 1979. Working with Israel Aircraft Industries (IAI), Israel sought to replace its aging A-4 aircraft, with an indigenously designed and built aircraft. This effort would help Israel gain an additional degree of self-sufficiency, fill in the Kfir production line which was to be phased out, and keep more than 20,000 workers employed in Israel's aircraft industry. -----DELETED-----  
-----DELETED-----Development costs at that point were estimated at \$750 million and the unit "fly-away" price was estimated at \$7 million, which did not include unit development costs.

By 1983, the estimated R&D costs had doubled from \$750 million to approximately \$1.5 billion and the estimated unit cost from \$7 million to 10.8 million. Thus the actual cost would be about \$15.5 million per aircraft. In comparison, an F-16A costs approximately \$12 million (FY82 dollars).

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Israel's basis was that the United States had begun selling advanced fighter aircraft to Arab confrontation states, thus threatening to erode Israel's qualitative edge. Israeli officials identified two other reasons to continue with the program:

- Israel could maintain its technology edge and the United States would not be under pressure to sell its most advanced fighter to the Arab states since the United States had not provided it to Israel.
- Israel would have an advanced aircraft industry that would provide considerable local employment and possible export monies.

Israel seeks large-scale U.S. financial  
and technical aid for Lavi

In 1980, Israel had approached DOD with the Lavi program concept and obtained agreement in principle for it to coproduce the General Electric engine. At that time, the United States had no objections to Israel using available FMS credits to procure components and materials in the United States for the engine. However, the United States would not agree, at that time to using FMS credits in Israel. As requirements for a more advanced fighter changed the original design and specification, the need developed for an engine with more thrust. The Pratt and Whitney 1120 engine was decided upon.

Israel requested that U.S. authorized FMS credits be spent in Israel for its Lavi program. It requested authorization to obligate nearly \$200 million in FMS credits in Israel for the Lavi engines and other components. DOD has authorized Israel's use of FMS credits to procure the Pratt and Whitney 1120 engine.

Israel began seeking U.S. and European companies to join as risk-sharing partners in Lavi, share in funding the R&D, and provide technical support. IAI has approached major U.S. aerospace firms, but without success thus far. U.S. industry representatives told us that IAI was asking U.S. aerospace companies to put up \$300 million in risk money and work for the program. They said that IAI found that no U.S. company was willing to risk this amount on the Israeli program but that one was willing to provide information on setting up integrated logistics support and how to build aircraft prototypes.

Since U.S. manufacturers turned down Israeli requests for direct funding or risk sharing, Israel hopes to offset the development costs by subcontracting some portions of Lavi with U.S. firms and to pay for them with U.S. assistance. This was the case when Israel obtained U.S. authorization to use \$181 million in FMS credits for the Pratt and Whitney engines.

The engine is still under development but is expected to have 60 to 70 percent interchangeable parts with the F-100 engine used on the F-16 and F-15 aircraft. The contract provides for licensed production in Israel for about 80 percent of the engine. This contract is seen by some DOD officials as setting the precedent for permitting FMS credits to procure U.S. subcontracts for the Lavi. Israel, at the time of our review, was the only buyer for this engine.

In April 1983, the administration had approved the export license requests of four U.S. aerospace firms that had submitted applications to conduct preliminary structural design work on the wing and tail. The competitive contract bids were valued at about \$1 million each. The selected U.S. firm would be expected to continue into further phases for prototype production and ultimately final production of wing and tail assemblies. Three of the firms told us that Israel would expect the selected U.S. firm to phase full production to Israel. In another case, Israel also requested DSAA authorization to spend ---DELETED--- in FMS credits on a U.S. firm's development of ----DELETED----- -DELETED- for the Lavi.

U.S. policy dilemma on supporting Lavi

DOD has been generally operating on the Lavi policy initiated by the previous administration. The current administration has been able to obtain more details concerning the project and define specific actions to be implemented under the policy. According to DOD, policymakers are considering the extent and conditions for permitting the use of FMS credits and the level of technology it is willing to release for U.S.-designed Lavi components. -----DELETED-----  
-----DELETED-----Some officials recognize the domestic, political, and economic repercussions for the United States of aiding a foreign country's aircraft program. Especially since we do not provide the same assistance to U.S.firms, for example, the recent Northrop F-20 effort. We have previously reported on an analogous situation regarding Japan.<sup>3</sup>

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<sup>3</sup>Report to the Chairman, Subcommittee on Trade, House Committee on Ways and Means, "U.S. Military Coproduction Programs Assist Japan in Developing Its Civil Aircraft Industry." (ID-82-23, Mar. 18, 1982.)

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CONCLUSION

There are various steps being taken, or being considered, which would result in U.S. security assistance being used to help expand Israel's defense industry and to develop its high technology military equipment that has export potential.

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Agency comments

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## CHAPTER 5

### PEACEKEEPING EFFORTS BROADEN U.S. COMMITMENTS

In accordance with the Egyptian-Israeli Peace Treaty of March 26, 1979, Israel withdrew from the Sinai in April 1982,<sup>1</sup> after 15 years of occupation and transferred the peninsula to Egyptian sovereignty. Recognizing the financial and strategic burden of the withdrawal on Israel and the need to help Egyptian transition from reliance on Soviet weaponry, the United States extended assistance to both countries. The assistance was provided in the form of foreign military sales (\$3.9 billion) and military and economic grants (\$1.1 billion) over a 3-year period--\$3.2 billion for Israel and \$1.8 billion for Egypt. The assistance was used to construct two highly-sophisticated forward combat airbases by the U.S. Corps of Engineers and Israel purchased military equipment from the United States for modernizing its defense and early warning capabilities.

The United States is also committed to continuing its participation in the peacekeeping mission in the Sinai as well as assuring Israel's security. A Memorandum of Agreement signed between the United States and Israel, in connection with the Egyptian-Israeli Peace Treaty, provides that if a violation of the Treaty is "deemed to threaten the security of Israel, the United States will 'consider' on an urgent basis such measures as the 'strengthening' of U.S. presence in the area, the providing of emergency supplies to Israel and the exercise of maritime rights in order to put an end to the violation."

#### COSTLY SINAI WITHDRAWAL

As a result of the treaty, Israel relinquished an extensive military infrastructure including air and naval bases, military installations, intelligence facilities and an early warning capability. For Israel's defense forces, this meant a loss in strategic depth. The return of naval facilities limited naval operations in the Red Sea and forced redeployment to other ports. Israel also had to return the oil fields along the western coast of the Sinai and lost its civilian settlements and infrastructure.

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<sup>1</sup>Except for the Taba area near Elat, where Israel had constructed a hotel on contended land.

Israel currently estimates that it will cost \$5 billion to relocate its armed forces. Originally, Israel's redeployment activities were estimated to cost around \$3.7 billion and take 3 years. Now Israel predicts it will take another 5 years, or until 1987, to complete the redeployment. This is because Israel has held back expenditures to lessen the impact on its construction industry and inflation rates.

#### U.S. AID DEFRAYS ISRAEL'S REDEPLOYMENT COSTS

The Special International Security Assistance Act of 1979 (Public Law 96-35, 93 Stat. 89) authorized \$4.8 billion supplemental security assistance in support of the peace treaty. For fiscal year 1981, an additional \$200 million was authorized in the Arms Export Control Act for financing additional redeployment costs. Israel received \$800 million in grant aid for air-base construction in the Negev Desert and \$2.4 billion in foreign military sales credits for financing the relocation of its forces. Egypt's package consisted of \$300 million in economic aid and \$1.5 billion in foreign military sales credits to modernize its armed forces.

In addition, the United States and Israel have entered into an arrangement to provide Israel with an oil supply source for its normal domestic consumption requirements since the return of the Sinai oil fields made it dependent on external sources. Israel is the only country that has such a bilateral agreement with the United States. Under the terms of the agreement, Israel will make its own independent arrangement for oil supply to meet its requirements through normal procedures. In the event Israel is unable to secure its needs in this way, the U.S. Government, upon notification of this fact by the Government of Israel, will make oil available at world market prices plus cost, if no quantitative restrictions exist on the ability of the United States to procure oil to meet its own normal requirements. If such quantitative restrictions do exist, the U.S. Government will make oil available for purchase by Israel in accordance with the International Energy Agency's conservation and allocation formula in order to meet the shortfall in Israel's essential requirements. Under the arrangement the U.S. Government will make every effort to help Israel secure the necessary means to transport, to Israel, the oil made available under the arrangement in the event Israel is unable to secure the necessary transport.

Israel has been granted a waiver, in accordance with Section 42 (c) of the Arms Export Control Act, to allow it the option of using FMS credits to procure articles normally purchased under the annual FMS authorization or to purchase construction materials either inside or outside of the United States.

U.S. assistance has enabled Israel to: (1) obtain two modern replacement airbases built by the U.S. Corps of Engineers with management assistance from the U.S. Air Force; (2) construct defense facilities and infrastructure in Israel; and (3) procure military articles and services for modernizing its armed forces and early warning equipment to offset the loss of the Sinai's tactical advantages. Israel is also building a third airbase with its own resources.

As of September 1, 1982, approximately \$2.3 billion or 72 percent of the special redeployment assistance available to Israel had been disbursed. The status of Israel's program follows:

Special Redeployment Assistance  
(in millions)

| <u>Purpose</u>  | <u>Authorized</u> | <u>9/01/82<br/>Disbursed</u> | <u>Israel's<br/>Revised<br/>Estimate</u> |
|---|-------------------|------------------------------|--|
| Airbase Construction  | \$1,040           | \$1,054                      | \$1,120                                  |
| Loan  | (240)             | (254) <u>a/</u>              |  |
| Grant   | (800)             | (800)                        |  |
| Local Construction<br>(Loan converted into<br>Israeli currency) | 1,254             | 702                          | 2,965                                    |
| Equipment Purchases   | <u>906</u>        | <u>531</u>                   | <u>906</u>                               |
| TOTAL   | <u>\$3,200</u>    | <u>\$2,287</u>               | <u>\$4,991</u> <u>b/</u>                 |

a/In addition to the FMS direct loan from the special assistance package, \$4.5 million was credited from a regular FMS case in April 1979 to fund start-up airbase construction costs prior to the special assistance authorization.

b/The balance in excess of authorized U.S. aid is to be financed by Israel's own resources.

Israel has held back spending the Sinai redeployment assistance, within the authorized 3 years, to lessen the impact on its economy.

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#### Use of redeployment funds

The portion of the plan funded by the FMS credit/grant assistance package comprises three parts: (1) construction in Israel by local contractors; (2) equipment purchases from the United States; and (3) the airbase construction project.

#### Local construction costs

More than 50 percent of the redeployment loans will be converted into Israeli shekels and spent within Israel for costs associated with relocating its Sinai forces. However, information on these expenditures was available only in the broadest context from Israel's general military construction records. The Israeli redeployment plan did note the following general areas to be constructed in the Negev for its defense forces:

- airfield infrastructure (excluding the two new airbases constructed by the United States);
- military schools and training bases;
- ground forces installations;
- communications relay systems and early warning installations;
- roads and utilities systems;
- housing facilities for military personnel; and
- logistics facilities.

Before the United States authorizes the purchase of foreign products with FMS credits, a determination is required to assure that procurement of such articles outside the United States will not result in adversely affecting the U.S. economy or industrial mobilization base. Thus, in November 1979, DSAA requested that Israel furnish the following supporting documentation for use of FMS funds to cover non-U.S. procurements:

- Identification of each relocation project for which funds are requested.
- Description of the goods and services which will be procured.
- Identification of the contractor to whom the funds will be paid.

However, this procedure was changed, according to a DSAA official, because it would have created a "paperwork burden" for Israel and could have hindered the timely completion of its withdrawal from the Sinai. Thus, DSAA, permitted drawdowns against the loan for in-country expenditures without documentation requirements, other than an Israeli request for reimbursement. Israel keeps receipts of all FMS offshore purchases for redeployment, but DSAA does not have a system to determine what is specifically procured with those funds converted into Israeli currency.

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#### Procurement of equipment for Israel's modernization plan

About \$900 million of redeployment aid was allocated for procuring defense articles and services to improve Israel's defense posture. Former Secretary of Defense Brown suggested types and quantities of equipment which the Israeli Defense Forces should acquire in conjunction with their ongoing modernization program. Israel agreed to all of the recommended items and other defense equipment.

Through the use of redeployment assistance funds, numerous items were added to Israel's inventory. It should be noted, however, that during 1980, a temporary change was made in the program. Israel was allowed to use these funds as necessary to fulfill its obligations under the FMS cash flow financing method. (See p. 21.) This was done until sufficient FMS funds were available to cover the obligations.

Building of highly sophisticated  
airbases

Relocating five squadrons of aircraft from several Sinai airfields created difficulties for Israel to comply with the Peace Treaty provisions. Construction of sophisticated replacement airbases would have placed "an extraordinary burden" on Israel's economy and construction industry and they had to be operational not later than April 25, 1982 (the treaty date for Israeli withdrawal). In the hope of facilitating a successful withdrawal and minimizing the economic consequences on the Israeli construction industry, the United States agreed to finance and construct two airbases.

The U.S. Corps of Engineers was assigned the role of construction agent, and assumed responsibility for executing the design and construction. The U.S. Air Force was designated the program manager with overall responsibility for the airbase program. Israel appointed its own program manager, as a counterpart to the U.S. Air Force program manager.

The original cost of the project was budgeted at \$1.04 billion. As of September 1982, the U.S. Corps of Engineers had estimated an increase to \$1.07 billion. In addition to the \$800 million U.S. grant, Israel had used \$254 million in FMS credits to finance construction.<sup>2</sup> Israeli officials estimate an even higher construction cost, \$1.1 billion, which includes other Israeli costs not previously billed to the project.

The completed airbases, considered among the most modern in the world by the Corps of Engineers, met the time limit imposed by the treaty. Even though the replacement airbases were originally planned to be replications of two forward combat airfields in the Sinai, requiring only site adaptation of as-built designs, the new bases are operationally more sophisticated. Many functional design changes were made to improve the facilities such as to provide maximum pilot and crew protection, and efficiently use minimal numbers of personnel for maintenance and operations.

The base layouts,-----DELETED-----  
-----DELETED----- are not comparable to any airbases the Corps of Engineers had built before. The Israeli program manager stated that these unique Israeli-designed shelters cost

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<sup>2</sup>(U)Originally the Israelis were to finance the balance with their own funds. Subsequently, they were allowed to use FMS credits for this per the Special International Assistance Act of 1979.

much more than the ones left in the Sinai but they offer important defense features considered critical.

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In addition, many redundant and survivability aspects were built into these facilities. For example, two nearly identical warehouses were built at each base in the event that one is damaged during combat. Each warehouse has the capability to automatically sort and retrieve supplies and parts and it can be operated with a minimum of three persons. Over \$10 million in redeployment aid was used to purchase the computerized systems installed at each warehouse.

Redundancy is viewed by Israeli officials as critical since they feel particularly vulnerable due to their limited number of fighter bases situated in a very small territory. The built-in redundancy, of course, raises construction costs. For example, the redundancy built into the fuel storage systems made them approximately twice as expensive.

#### Turnover of construction equipment and structures

Within 3 years of the treaty ratification, the two airbases were functional with the capability of operating two fighter aircraft squadrons from each base under combat conditions. A major contributing factor to meeting the treaty-imposed deadline was the use of "fast track" procedures to perform design and construction simultaneously. Much of the construction equipment, building materials and supplies was purchased by the Corp of Engineers with funds from the \$800 million grant for Israel before contracts and drawings were defined to speed delivery. Furthermore, new equipment was purchased rather than leasing or procuring used equipment, to preclude costly and time consuming breakdowns due to around-the-clock usage.

The equipment did not break down as anticipated and, at the project's conclusion, one Corps of Engineer official noted that the construction equipment was generally in excellent condition. All of this equipment, as well as excess materials and supplies, was titled to Israel, in accordance with the country-to-country agreement. At the conclusion of the project, Israel either sold the items outside of Israel or transferred them to other Israeli projects. For example, approximately \$1 million worth of structures, building materials and office supplies was

purchased by the multinational peacekeeping organization in the Sinai. Since the United States pays for the peacekeeping force along with Egypt and Israel (see p. 72), this means it, in essence, repurchased part of the equipment.

A U.S. Corps of Engineers official told us that leaving construction equipment and excess materials and supplies behind at the end of a project is not the usual practice in the United States nor in Saudi Arabia where the Corps is also involved in major building efforts. In this case, though, a prime consideration was to avoid seriously affecting the Israeli economy by selling construction equipment on the open market. Bringing the equipment back to the United States for resale was not considered economically viable because of the equipment's anticipated heavy wear.

Therefore, in accordance with the country-to-country agreement, construction equipment and building materials and supplies, amounting to \$172 million of the contract, that remained were titled to the Government of Israel. To the extent that the remaining items are of value to Israel, and this seems to have been the case in most instances, it offsets much of the additional costs that Israel incurred for the construction.

Israeli request for an increase  
in U.S. redeployment assistance

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Terms of the Sinai redeployment funds may be modified in accordance with the Act, if the Congress determines that the redeployment is too heavy an economic burden for Israel. In this regard, a March 1981 U.S. report stated that the "Sinai redeployment aid from the U.S. is more than enough to cover the foreign exchange costs of the Israeli pullback from the Sinai".

U.S. oversight of  
redemption expenditures

Equipment purchases were processed essentially the same as under regular FMS procedures, with one exception. Every contract, regardless of amount, required prior approval under the redeployment FMS, unlike regular FMS where only contracts over \$1 million require prior DSAA approval.



Regarding conversion of FMS credits into Israeli currency for local construction, where no U.S. contracts are involved, DSAA required an Israeli request for reimbursement. Payments to local construction contractors were administered similarly to the previous offshore procurement project for Israel's Merkava tank. For redeployment, Israel proposed a "simple, streamlined" procedure, which DSAA accepted, to avoid hampering work progress. DSAA required little documentation but said that the Israelis made every effort to accurately track U.S. funds and that the applicable receipts are available for U.S. review. A major stumbling block in U.S. review of such expenditures would be the long time it would take to reconcile the high volume of transactions and the difficulty in positively determining whether they were used for redeployment.

#### DEEPENING U.S. INVOLVEMENT IN PEACEKEEPING EFFORTS

When Israel completed its Sinai withdrawal, U.S. involvement in Sinai peacekeeping activities rose from a 162-person civilian operation, known as the Sinai Support Mission and its overseas arm, the Sinai Field Mission, to nearly 1,230 U.S. military personnel and civilians in the Multinational Force and Observers (MFO). A major change in the focus is that the United States is no longer the sole funding source nor the single agency monitoring movements in the Sinai.

From 1976 to 1982, the Sinai Field Mission helped assure peace in the Sinai. A key duty of that operation from the time of its inception until April 1980, was to staff an early warning electronic station and monitor the approaches to strategic mountain passes. From April 1980 until the missions termination in April 1982, the Sinai Field Mission conducted mobile verification inspections over two-thirds of the Sinai in fulfillment of the terms of Annex I of the Egypt-Israel Peace Treaty.

The Protocol signed by Egypt and Israel, and witnessed by the United States, established the MFO on August 3, 1981. Its size is limited to not more than 2,000 infantry troops plus a coastal unit, an observer unit, an aviation element and logistics and signal units.

On April 25, 1982, the MFO assumed peacekeeping responsibilities for implementing the following provisions of the Israel-Egypt Peace Treaty:<sup>3</sup>

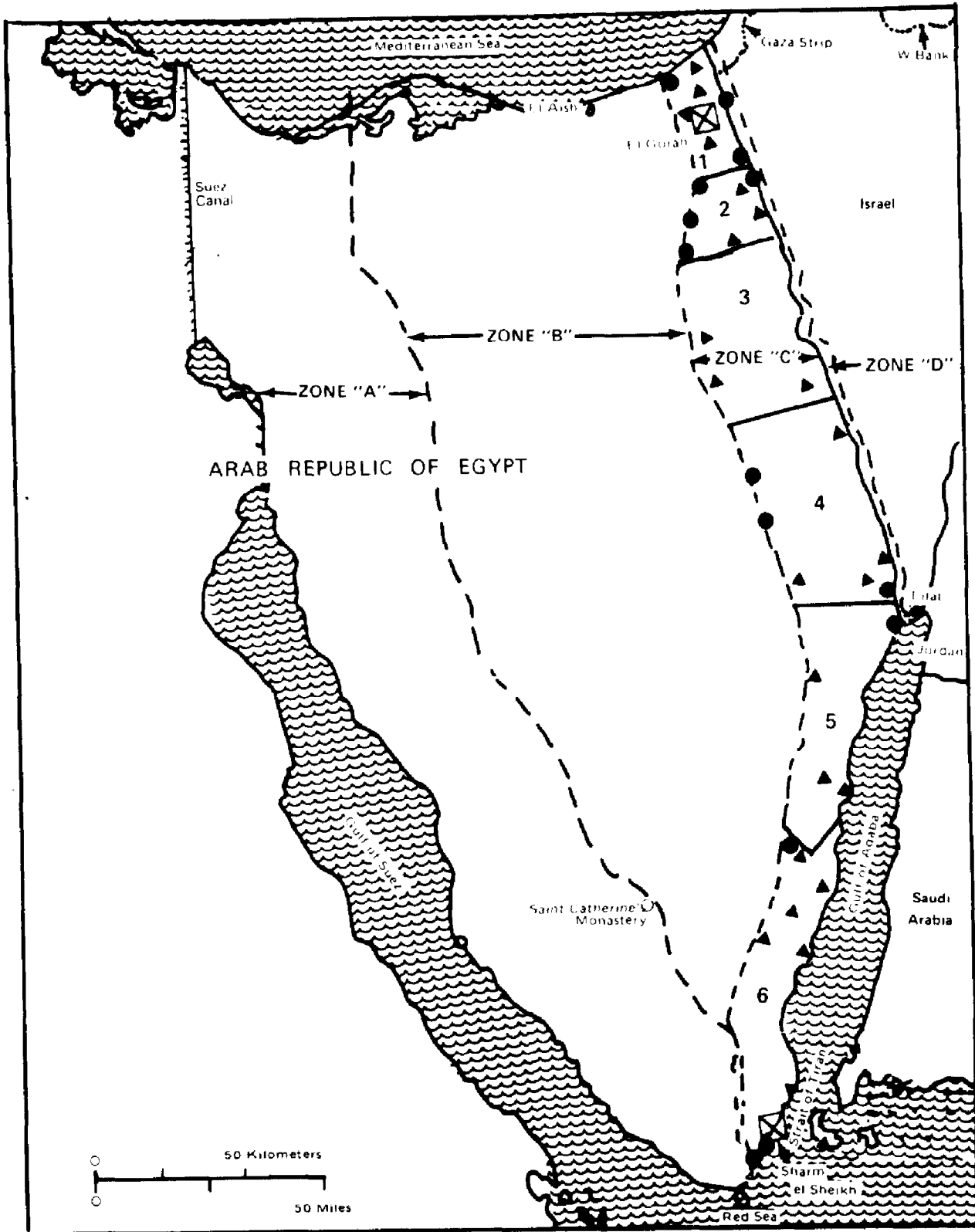
- (1) to operate checkpoints and reconnaissance patrols and observation posts along a 250-mile boundary line and within Zone C;

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<sup>3</sup>For specific locations see map on the next page.

# MULTINATIONAL FORCE AND OBSERVERS POSITIONS

## SINAI PENINSULA



▲ OBSERVATION POST

1 - 6 SECTOR

● CHECKPOINT

⊠ MAIN BASES

- (2) to verify at least twice a month and upon request by either party the Treaty provisions; and
- (3) to ensure freedom of navigation through the Strait of Tiran.

The 2,725-member MFO is currently comprised of contingents from 11 countries. The United States supplies the largest number of personnel and, pursuant to agreements with Israel and Egypt, pays for one-third of the MFO's operating costs. In accordance with P.L. 97-132, the United States must limit the total U.S. military personnel complement to a maximum of 1,200. The other developed country participants could be considered as contributing "in kind" as they are not reimbursed for the salaries of their troops nor their regular operational expenses but, like the United States, are reimbursed for those additional costs occasioned by their service with the MFO. The developing countries (Colombia, Fiji, and Uruguay), however, are reimbursed for troop salaries and other costs according to the U.N. scale of reimbursements for participation in U.N. peacekeeping activities.

The equipment and manpower furnished by country as of April 1983, are as follows:

| <u>United States</u>                           | <u>Personnel</u> |
|--|------------------|
| Light infantry battalion and<br>10 helicopters | 808              |
| Logistics support unit                         | 356              |
| Director General and Force<br>Commander staff  | 33               |
| Civilian observers                             | 35               |
| <u>Colombia</u>                                |                  |
| Light infantry battalion                       | 498              |
| <u>Fiji</u>                                    |                  |
| Light infantry battalion                       | 497              |
| <u>Italy</u>                                   |                  |
| Three minesweepers                             | 87               |
| <u>Australia &amp; New Zealand</u>             |                  |
| 10 helicopters and crews                       | 124              |

|   |              |
|---|--------------|
| <u>Uruguay</u>                                      |              |
| Transportation unit                                 | 73           |
| <u>France</u>                                       |              |
| Two utility aircraft, one cargo<br>plane plus crews | 35           |
| <u>United Kingdom</u>                               |              |
| Administrative support staff                        | 35           |
| <u>The Netherlands</u>                              |              |
| Signal units (81) and military<br>police (23)       | 104          |
| <u>Norway</u>                                       |              |
| Force Commander's staff<br>(73, including U.S.)     | <u>40</u>    |
| Total force and observers                           | <u>2,725</u> |

The United States agreed to pay 60 percent of the MFO start-up costs and, thereafter, to share equally in providing the MFO operating budget with Israel and Egypt. The contribution for the first 2 years was \$135 million and will be about \$35 million in fiscal year 1983. Israel and Egypt paid \$45 million each during the first 2 years and will pay about \$35 million each in fiscal year 1983.

#### Indefinite U.S. commitment

The duration of U.S. participation is open ended, but subject to congressional authorization and the appropriation process. In September 1981, we reported to the Chairman of the Senate Committee on Foreign Relations<sup>4</sup> on the U.S. role in the alignment Mid-East peace process. One of our matters for consideration to the Congress was that the agreement called for a U.N. peacekeeping force, if possible, and that this should be the ultimate objective. Congressional interest is noted in P.L. 97-132, December 29, 1981, 95 Stat. 1693, which authorizes U.S. participation in the MFO. It directs the President to report annually "the results of any discussions with Egypt and Israel regarding the future of the Multinational Force and Observers and its possible reduction or elimination."

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<sup>4</sup>"U.S. Role in Sinai Important to Mideast Peace" (ID-81-62, Sept. 9, 1981).

Under the terms of the 1981 protocol, both Israel and Egypt must agree to any alteration in the basic size and function of the MFO before changes occur. Moving to simpler arrangements at some point in the future may be a first step in disbanding the MFO. The former Sinai Support Mission reported that "the traditional approach to the problem of monitoring a border or a restricted area usually involves the wide-scale use of a combination of fixed observation posts and roving patrols." For this approach to be effective, which is similar to the MFO operation, a large number of people must be employed.

The Sinai Support Mission suggested in a 1980 publication, that "by using modern surveillance technology, one person located at a central monitoring facility can 'watch' a border or area that would normally require a substantial force to patrol." It suggested that the application of such concepts could make a "valuable and cost-effective contribution" to peacekeeping efforts. However, this may not be as practical for the MFO because the area being monitored is not confined to two mountain passes as was the case for the Sinai Field Mission. The cost of acquiring and monitoring sufficient amounts of surveillance equipment may mitigate against this. Further, a MFO official noted that the physical presence of military personnel, particularly U.S. forces, may serve as a better deterrent against treaty violations.

#### Role of U.S. troops

The battalion of U.S. troops is based at the southern tip of the Sinai near Sharm El Sheikh. The logistics support unit and the civilian observers are located in the northern Sinai near El Gorah. The U.S. contingent is responsible for staffing 10 observation posts and four checkpoints, in sectors 5 and 6 (see map on p. 70) plus a few logistic facilities. Three platoons are rotated to the field for 24-hour watch duty including foot and mobile patrols in proximity of the outposts.

The U.S. forces and civilians rotate on different schedules. The Americans working on the Force Commander's staff serve for 1 year, the Chief of Staff serves 2 years, and the observers serve for 1 year. The infantry troops and logistics personnel are assigned to the Sinai for 6-month periods. The rotation is not staggered, so each new U.S. contingent results in a complete turnover. Every 6 months, a battalion spends 1 month or more in training prior to its detachment and the same battalion loses about one month on its return to regular U.S. forces. This translates into 8 months of duty to complete a 6-month tour. A DOD official said that it may be more efficient to increase the tour of duty to 1 year, at least for the 356 logistic support unit personnel who are harder to replace and take longer to train. Transportation costs alone would be a

substantial savings to the MFO. DOD is currently considering changing the length of the MFO tour.

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#### U.S. liaison to the MFO

A need for a U.S. Government focal point to handle U.S. participation in the MFO was also stated as a concern in our September 1981 report. In March 1982, the Department of State established a Multinational Force and Observers office in the Bureau of Near Eastern and South Asian Affairs (NEA/MFO) to provide liaison support. This office is more specialized and only about half the size of its predecessor, the Sinai Support Mission. Six persons are employed to prepare and justify budget requests, coordinate interagency support, provide administrative support, and recruit civilian observers.

The Congress requires annual status reports from the President on MFO activities and its associated costs for the United States. The NEA/MFO office transmitted its first report to the Congress on June 23, 1982<sup>5</sup>. This report covers only a few months of operation and is basically a report on those U.S. costs associated with the MFO startup and construction related activities. According to the report, the State Department billed the MFO \$98,261 for costs associated with the U.S. unit and participating personnel and for identifiable costs relating to property, support, and services provided by the United States.

#### Reimbursed U.S. costs

The MFO is required to reimburse the United States for costs incurred as a result of MFO-imposed requirements. State and DOD stated that all payments have been received on a timely basis. During fiscal year 1982 the MFO was billed by the State and Defense Departments for more than \$20 million. State Department reported that the MFO reimbursed State and DOD for these billings. The July-September bills show costs ranging

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<sup>5</sup>(U)The report was due on April 30, 1982, in accordance with Pub.L. 97-132, but was submitted late.

from \$1,710,600 for 12 helicopter engines to a \$20 charge for painting ambulances.

Israel billed the MFO approximately \$6 million for pre-fabricated buildings, communications equipment, and life support systems. Much of this equipment was taken from the vacated air bases in the Sinai.

Sinai Field Mission equipment transferred at no cost

Although the resolution governing U.S. participation in the MFO, said that all nonreimbursable U.S. costs "shall be kept to a minimum" the MFO was not billed for equipment transferred from the dismantled Sinai Field Mission. The State Department commented that a determination was made that transfer of foreign excess personal property to the MFO on a non-reimbursable basis would result in "substantial benefits" to the United States. This equipment, which consisted of movable property, construction equipment and communication equipment was originally purchased for \$2.6 million. According to the NEA/MFO report, a majority of this equipment "was acquired between 1976 and 1978 and it was near the end of its useful life." About 30 percent of the equipment, however, was in good to excellent condition, according to the condition codes listed on the equipment print-out, and includes relatively new vehicles and unused spare parts.

The Sinai Field Mission also transferred vehicles and other equipment to the U.S. Embassies in Egypt and Israel (which were given first choice on all items) and the base camp was turned over to the Government of Egypt in an operable condition at no cost. All of the recipients were required to pick up and transport it at their own expense, including the U.S. Embassies. According to a Sinai Field Mission report, in this way, it was able to dispose of excess equipment and phase out the Mission's operation in a rapid and efficient fashion. The NEA/MFO's January 1983 report stated that a value for the items provided without charge to the MFO from the dismantled Sinai Field Mission was difficult to assess.

## CHAPTER 6

### OVERALL CONSIDERATIONS FOR U.S. ASSISTANCE

Israel's relationship with the United States, and the strong U.S. support and assistance for its defense, is founded on its staunch U.S. friendship and on its position as a democratic form of government in the Middle East region. The relationship has been supported by much of the American public and the Congress has often been willing to raise the levels of security assistance beyond the amounts requested by the executive branch. Israel has also been granted liberal concessions in the way the assistance is applied. Were these concessions not provided, additional assistance may have been requested.

As other countries in the region obtain more sophisticated weaponry, without full peaceful relations between these countries and Israel, Israel perceives that the Arabs present a greater potential threat to its existence than U.S. officials believe is present. Since the United States and the Soviet Union are the source of most of the weapons to countries in the region, either through assistance or arms sales, a growing dilemma exists for the United States as to how much assistance it can provide to maintain a proper balance between these opposing factions. Without peace, U.S. costs and arms transfers to the Middle East continue to escalate, thus complicating U.S. considerations in approving further arms sales and military assistance. For Israel, it makes it difficult for U.S. planners to mutually agree with Israel on its real military needs and how much of those needs the United States can support.

This planning effort is beginning to be further complicated because much of the assistance for Israel has been provided by the FMS program under long-term loans for which principal repayments are just now starting to come due. For Israel to be able to maintain what it considers to be adequate defense while at the same time repaying past borrowing, it most likely will need to ask the United States for financing terms even more liberal than those granted in the past.

We take no position on the level or terms of assistance to Israel but believe the precedents being set by the liberalized methods in implementing the program could be a problem if other recipient countries ask for similar concessions. Examples of granted liberalized techniques follow:

- Israel was the first beneficiary of the cash flow method of financing which allows a country to set aside only the amount of money needed to meet the current year's cash requirement for multiyear production contracts rather than the full amount.



This has allowed the countries to stretch buying power and place more orders than the available credit guarantees authorized in a given year. This implies a commitment for the Congress to approve large financing programs in future years to ensure that signed contracts are honored. Egypt and Turkey are more recent users of this technique.

--Israel has been forgiven (allowed write off of) a substantial portion of the FMS loan program (\$750 million of \$1.7 billion for fiscal year 1983). Now other countries have received the same benefit (Egypt and Sudan). Israel has also requested and received the forgiven portion of the FMS loans before drawing down the interest-bearing repayable part of the loans. This defers its interest expenses.

--Israel is receiving an ESF grant totaling \$785 million in fiscal year 1983, making it the largest ESF recipient. Funds are provided to Israel as a cash transfer, not tied to development projects as is the case for many other countries.

--Israel receives trade offset arrangements from U.S. firms when it makes FMS purchases. Offsets are commitments by U.S. firms to purchase a specified amount of Israeli goods or services. Such arrangements are common under commercial arms sales but unusual under FMS.

--Israel has been provided with military technologies having export potential. This could adversely impact on the U.S. economy and can affect U.S. ability to control proliferation of these technologies.

Israel has also asked for additional concessions to assist in further stretching its assistance. For example;

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--Israel requested in 1982 that ESF funds be disbursed in a single payment at the beginning of the year. This would cost the U.S. Government in excess of \$40 million in interest annually when compared to the usual quarterly disbursement of ESF funds. There have been no recent discussions of this matter.

--Israel is seeking to increase its annual military sales to the U.S. defense establishment to about \$200 million.

--Israel is requesting more Sinai redeployment assistance although it has been provided two modern airbases, been allowed to use FMS credits for its share of the costs, and acquired the leftover construction equipment.

In deciding the structure of the military aid package to Israel, the United States is faced with considerations of Israeli policies that sometimes differ with U.S. foreign policy. As is the case for any independent and sovereign recipient, foreign assistance for Israel is not directly tied to whether it fully agrees with the United States or always acts in accordance with U.S. wishes. However, as differences arise, some elements of the U.S. public and the Government find this frustrating. Israel has used U.S.-furnished weapons in Iraq and Lebanon in a manner which, the administration has stated, may have violated the agreements under which they were provided. However, we believe it is unlikely that U.S. officials would be willing, as a practical matter, to cut off the flow of weapons as the law provides when violations occur. Israel has also occupied areas outside its borders--Lebanon, Golan, the West Bank and Gaza. U.S. policymakers question such moves but recognize Israel's fears that its enemies are otherwise too close. The costs of such actions can have an impact on Israeli requests for U.S. support.

We believe the trends toward increasing assistance requirements, greater relaxation of restrictions on the use of FMS funds, competition with U.S. production, and setting of precedents that others may seek to emulate will continue as long as Israel feels militarily threatened by its neighbors in the region. It is clear that the ultimate solution to Israel's security depends upon a negotiated settlement with its Arab neighbors.

In summary, the United States is faced with questions regarding the Israeli assistance program along with other countries that are not easily resolved. Among these are:

1. What is the impact of U.S. programs and policies on the spiraling Middle East and world arms race?
2. What are the potential impacts and increased costs to the United States if other recipients ask for and receive concessions similar to those of a precedent setting nature in the Israeli program?
3. To what extent might Israel ask for increased U.S. assistance levels and concessions to be able to repay mounting debt servicing requirements to the United States?

#### AGENCY COMMENTS AND EVALUATION

Agency comments were solicited and provided by the Departments of Defense, the Treasury and State, the Central Intelligence Agency and the Agency for International Development. We appreciate the attention given to our report and the general positive nature of comments, updates and suggested changes. We have incorporated all suggested changes that bear on clarification of positions, and updating the facts of the report. In other areas we noted disagreements of the various positions and have presented them where they are discussed in the report.

We concur with the State Department, the Treasury and AID's assessment that U.S. financial flows to Israel remain heavily positive. Additionally, we share their concern about the need for continued separation of the ESF program and FMS repayments. Our report points out that the FMS loans and principal repayments will continue to grow. Treasury, AID and State concur. But we also point out that FMS repayments combined with factors affecting Israel's balance of payments could alter Israel's ability to pay its debt. The State Department and AID disagreed. State reported that they do not foresee the development of a severe debt situation. AID stated that there is cause for optimism about Israel's balance of payment prospects. We noted that there may be more pressure to increase assistance. We therefore have modified the report to incorporate the other view.

We concur with the State Department that this report highlights the intensive arguments of the arms situation of the Arab-Israeli dispute. Taken alone this one element of the report may present a limited perspective of the issues in this regional arms race. If one were to incorporate all of our

recent reports in the area, a more detailed and pluralistic viewpoint of the arms race is presented as well as the multiplicity of other factors affecting arms decisions. Nonetheless the premise of this report is valid in that the Arab-Israeli dispute remains a major element in the increase of arms to the region.

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DEPARTMENT OF STATE  
*Comptroller*  
Washington, D.C. 20520

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May 16, 1983

Dear Frank:

I am replying to your letter of March 24, 1983, which forwarded copies of the draft report: "U.S. Assistance to the State of Israel."

The enclosed comments on this report were prepared by the Deputy Assistant Secretary in the Bureau of Near Eastern and South Asian Affairs.

We appreciate having had the opportunity to review and comment on the draft report. If I may be of further assistance, I trust you will let me know.

Sincerely,

  
Roger J. Feldman

Enclosure:  
As stated.

Mr. Frank C. Conahan,  
Director,  
International Division,  
U.S. General Accounting Office,  
Washington, D.C.

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**pgs. 82 through 84 DELETED**

**SECRET**INTERNATIONAL  
SECURITY AFFAIRS

OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE

WASHINGTON, D.C. 20301

I-22206/83

20 MAY 1983

Mr. Frank Conahan  
Director, International Division  
U.S. General Accounting Office  
Washington, D.C. 20548

Dear Mr. Conahan:

This is the Department of Defense response to your draft report, "U.S. Assistance to the State of Israel," dated March 24, 1983, GAO Code #463675 (OSD Case #6225).

Detailed comments to your proposed findings, conclusions and recommendations are contained in the enclosure. As you note, while DoD agrees with the majority of the draft report, there are some concerns. In these instances, DoD is providing additional information and clarifying comments as appropriate. We will be providing by separate letter a "mark-up" copy of the report with classifications, updates, and technical corrections.

We appreciate the thoroughness of GAO's review of this important foreign policy area, and the opportunity to comment on the draft report.

Sincerely,

Handwritten signature of Richard L. Armitage in cursive script.

RICHARD L. ARMITAGE  
Assistant Secretary of Defense  
(International Security Affairs)

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FROM CLASSIFIED ENCLOSURES

**SECRET**

DOD's attachment is not included because it is classified.





ASSISTANT SECRETARY

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DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

May 23, 1983

Dear Mr. Conahan:

Thank you for the chance to comment on the proposed GAO report "U.S. Assistance to the State of Israel." It reflects extensive research and careful analysis on a most important and sensitive subject.

We agree with the general thrust of your conclusions.

We do have some specific textual comments which are enclosed for your consideration.

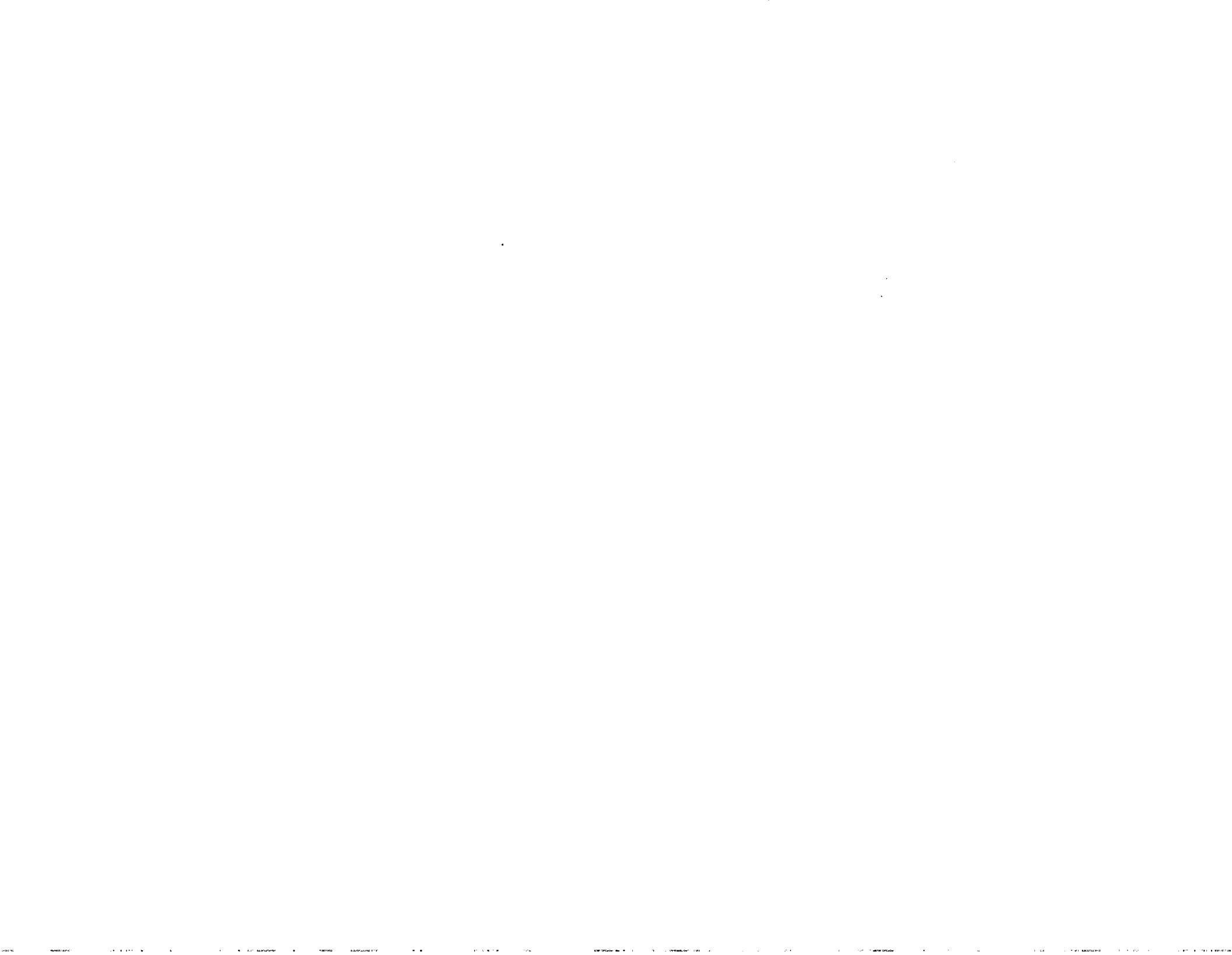
Sincerely,

Marc E. Leland  
Assistant Secretary  
International Affairs

Mr. Frank C. Conahan  
Director  
United States General  
Accounting Office  
Washington, D.C. 20548

Enclosure

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the optimistic export growth targets which it has set for itself, it does not follow that ESF levels will have to rise to avoid a debt problem. In fact, while it is difficult to make balance of payments projections beyond the immediate future, it appears to us unlikely that Israel will need to devote any greater percentage of its foreign exchange earnings for debt service during the next several years than it did in 1982. Indeed, it is more likely that the debt service burden will be reduced.

Furthermore, in an overall sense, we do not believe it is useful to imply a linkage between U.S. assistance levels to any country and debt service obligations to the U.S. Currently, there are a number of countries where debt obligations exceed annual U.S. assistance levels and a number of others which are approaching those levels. We have taken the position that assistance must be based on overall U.S. foreign policy interests, recipient country needs, and budgetary availabilities.

For these reasons, we feel that the report ought not to highlight projected trends in the level of ESF assistance on the one hand and FMS debt service obligation on the other. I suggest the report be modified to delete all statements which presume that the two are linked, for they definitely are not. There are many such statements. Without trying to be all inclusive, I would like to draw your attention to pages iv, 36, 51, 52, 53 and 115.

I would also like to comment on the statement at the top of page 41 to the effect that the Israel program established an unfortunate precedent by providing cash transfers in lieu of projectized assistance for economic development activities. A.I.D. programs are designed with the needs of individual recipient countries in mind. Where fast disbursing assistance for balance of payments support is called for, a cash transfer may be the most appropriate vehicle. Israel is not the first country to receive this kind of assistance, nor is it likely to be the last. Nevertheless, economic development remains a key concern, and project assistance is utilized wherever possible. I think our program worldwide fully reflects this emphasis.

The following are a number of relatively minor points that I believe should be corrected or clarified:

-On pages iii and iv, the report states that no action has been taken on Israel's request that ESF funds be disbursed in one payment at the beginning of the fiscal year. This is incorrect. We advised the Government of Israel that we preferred to continue with quarterly disbursements.

UNITED STATES INTERNATIONAL DEVELOPMENT COOPERATION AGENCY  
 AGENCY FOR INTERNATIONAL DEVELOPMENT  
 WASHINGTON D C 20523



THE ADMINISTRATOR

9 MAY 1964

Dear Mr. Conahan:

Thank you for providing A.I.D. with copies of the draft report on "U.S. Assistance to the State of Israel". It contains a useful review of our economic assistance to Israel since the initiation of the cash transfer program. While the report does not include any specific recommendations, I would like to clarify a number of points and comment on certain others related to the ESF-funded assistance.

As the report indicates, based on current levels of economic assistance, security assistance repayments will exceed ESF-funded balance of payments support by increasing amounts in the years ahead. Concern is expressed throughout the report regarding this widening gap. I would like to point out that economic assistance is provided to Israel to assist it in financing its non-defense balance of payments shortfall, not to service debt owed to the U.S. Government. Debt service obligations are but one element in the balance of payments, and not necessarily even the most significant one. Our assistance permits Israel to pay for imports of non-defense goods and services, service debt, build up foreign exchange reserves, etc. It is not possible to attribute the cash resources which we provide to particular foreign exchange uses such as servicing debt.

While your report correctly indicates that debt service obligations -- including those owed the U.S. Government -- will rise in the years ahead, it is not at all evident that there will be a deterioration in the balance of payments. On the contrary, there is cause for optimism about Israel's balance of payments prospects in the context of a modest economic recovery in the West and economic policies in Israel which support export-led growth. Even if Israel is unable to fully achieve

Mr. Frank C. Conahan  
 Director  
 International Division  
 United States General Accounting Office  
 Washington, D.C. 20548

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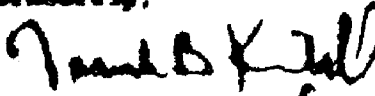
-On page 18 under the heading "Congressional role", there is a statement which implies that Congress took the lead in securing IMF assistance for Israel on a cash basis. While Congress earmarked the funds, it was the Executive Branch which first requested a shift from commodity import financing to cash assistance in 1978.

-The report refers on page 24 to a "net flow of funds from Israel to the United States under the Security Assistance Program". There is no net outflow to the U.S. under the program. For FY 1983, IMF and FIMB assistance total \$2,485 billion, more than \$1.4 billion higher than estimated debt service due the U.S. Government from Israel for the same period.

-It should be noted on pages 39 and 44 that the Administration's request to Congress for FY 1984 is for an all grant IMF program.

Thank you for the opportunity to comment on the draft report.

Sincerely,

  
R. Peter Hetherington



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