



# New Deal, New Consequences: US Security Assistance Pact Poses Challenges for Israel's Defense Sector

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## Introduction

When the new 10-year security assistance Memorandum of Understanding (MOU) between the United States and the State of Israel takes effect in US fiscal year 2019, military cooperation between the two longtime allies will be assured through 2028. However, the new 10-year agreement will have a potentially negative impact on the Israeli defense sector – including increased reliance on exports, industry consolidation, job losses, and hampered innovation – unless Israeli industry starts preparing for the deal's consequences.

## Offshore Procurement & Fuel Purchasing Phase-Out

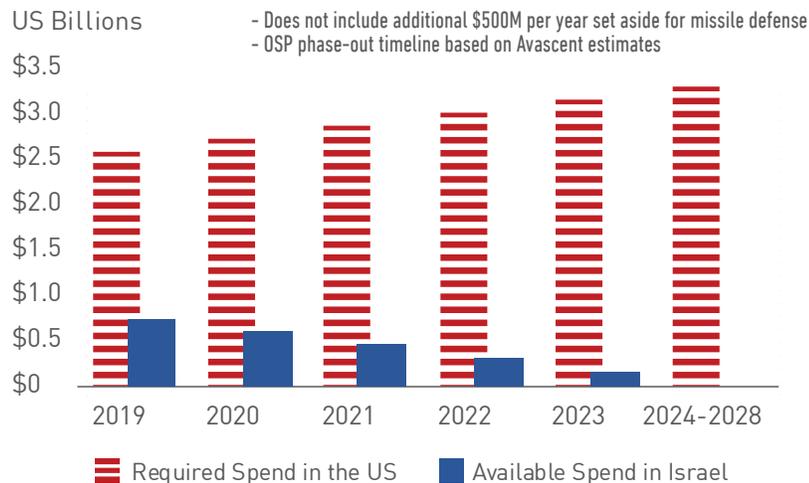
Although the new MOU's \$3.8B per year commitment is an increase of over 20% in absolute dollars, \$500M of those dollars are set aside for missile defense spending. Moreover, the remaining \$3.3B in foreign military financing (FMF) includes important changes. Most significant is

the alteration to the Offshore Procurement (OSP) provision, which grants Israel the ability to spend 26.3% (approximately \$815M in 2015) of US aid within Israel on non-US products. Beginning in 2019, this will gradually phase-out over a six-year period; by 2024, Israel will be obligated to spend all FMF in the US. Additionally, Israel will no longer be permitted to spend US dollars on fuel, which accounts for approximately 13% of its current FMF expenditure.

## Impact on Israel's Defense Sector

The current OSP arrangement was instrumental in developing Israel's defense industry by enabling the government to spend hundreds of millions of dollars on procuring and modernizing equipment and weapon systems developed in-country. This has enabled Israel to become one of the world's top 10 defense exporters; in 2015, Israel's defense exports totaled \$5.7 billion, 14% of all exports.

## Offshore Procurement Phase-Out



Due to the OSP phase-out, four significant changes may occur in Israel's defense sector with both near- and long-term consequences:

### 1) Increased Reliance on Exports:

Currently, one-quarter of the Ministry of Defense's military procurement is spent on US-made equipment due to the MOU's current FMF requirements. Consequently, according to the US Library of Congress, many Israeli companies must export 75% of their products to stay profitable. By requiring increased FMF spending on American equipment, the OSP phase-out will further deprive Israeli companies of a domestic customer, increasing the defense industry's reliance on exports to survive.

### 2) Industry Consolidation:

In 2015, Israel spent approximately \$6.8 billion of its defense budget on procurement, operations, and sustainment. The annual loss of \$815 million dollars to spend in Israel represents a 12% reduction in domestically available

defense dollars for these purposes.

Moreover, the inability to spend future FMF dollars on fuel will likely require the government to divert money from other accounts to compensate, creating defense-wide budgetary pressures. This new fiscal climate may cause a wave of industry consolidation, as small- and medium-sized defense firms will likely struggle to survive amidst an increasingly competitive environment.

**3) Job Loss and Brain Drain:** According to Israel's Manufacturer's Association, for every \$265 million (NIS 1 billion) cut in the defense budget, about 2,000 workers will be laid off. This could amount to approximately 11,000 jobs lost by 2024, when the phase-out is complete. While the MOU's higher dollar value and Israel's robust economy may offset some of this effect, the looming threat of the OSP phase-out and likely layoffs may foster uncertainty in the defense sector, potentially driving highly-qualified personnel to seek opportunities abroad or outside the defense industry.

### 4) Reduced Defense and Commercial Innovation:

As Israel's defense industry is a significant contributor to the country's entrepreneurial "start-up" scene, cutting hundreds of millions of dollars – and thousands of jobs – could diminish the vibrancy of its defense-derived technological innovations that impact a wide range of markets, including drones, data storage, and firewall software. PillCam, Through-Wall Vision, and dozens of other commercially successful products have their roots in military programs or applications. In the future, many emerging defense technology programs, products or applications may falter early on due to diminished R&D funding.



As the FMF dollars Israel can spend locally diminishes over the course of the OSP phase-out, Israeli defense firms should look to expand their global market channels.



## Preparing for a New Era in US FMF

Although the OSP modifications will not take immediate effect, the new budgetary and competitive landscape requires well-considered strategic planning. To best prepare for this future state, Israeli firms should consider two options:

**1 Establish a US Footprint:**  
The new requirements encourage Israeli firms to establish subsidiary offices in the United States, as transferring manufacturing capabilities to the US will make it easier to sell to the world's largest defense customer: the US Department of Defense (DoD). Additionally, the development efforts of critical Israeli technology (e.g. the Tzayad Digital Army Program) will no longer have access to early stage R&D funding from FMF. Thus, Israeli companies developing such programs should look to bolster their US presence to ensure their efforts will remain funded.

**2 Export Market Penetration:**  
As the FMF dollars Israel can spend locally diminishes over the course of the Offshore Procurement phase-out, Israeli defense firms should look to expand their global market channels. Increasing their international presence can offset domestic competitive pressures and create new growth opportunities. Given the increased importance of exports to Israel's defense sector and the country's strong reputation in global defense markets, developing more robust and assured export pipelines is both imperative and achievable.

## About the Authors

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