

European Defence Markets and Industries: New Initiatives, New Challenges

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Abstract

The author discusses how the excessive focus of European countries on national priorities have been leading to a number of structural problems, in the European defence market, related to international competition, military redundancies and unnecessary costs. The article reflects on the recent efforts by the EU to support the European Defense and Technological Industrial Base and it concludes with some thoughts on the challenges facing the EU and the European defence market. The paper is structured in three major parts. First, it provides an overview of recent initiatives on EU defence. Second, it examines the latest developments designed to turn these initiatives into action. Third, it concludes by outlining some strategic elements important in the context of future European defence, notably the required balance between the political will of Member States, the European financial incentives for defence and the potential interest of European industry on these incentives.

Resumo

O Mercado Europeu da Defesa e as Indústrias: Novas Iniciativas, Novos Desafios

O autor parte da afirmação de que, uma excessiva atenção dos países europeus sobre as suas prioridades nacionais no plano da defesa tem causado problemas estruturais no âmbito do mercado de defesa europeu relacionados com questões de concorrência, redundância de meios militares e desnecessários custos adicionais. Examinam-se os esforços recentemente desenvolvidos relativos ao apoio da Base Industrial e Tecnológica da Defesa Europeia e conclui refletindo sobre os desafios que a União Europeia e o mercado de defesa europeu enfrentam. O artigo estrutura-se em três partes. A primeira oferece uma perspetiva sobre as iniciativas recentemente desenvolvidas no domínio da defesa europeia. A segunda examina em que medida aqueles desenvolvimentos se têm traduzido em ações concretas no quadro da defesa europeia. Por último, conclui com algumas considerações estratégicas importantes no quadro do futuro da defesa europeia, nomeadamente o equilíbrio a alcançar entre a vontade dos Estados Membros, os incentivos europeus no plano da defesa e o interesse da indústria europeia em utilizar aqueles incentivos.

Introduction

It is difficult to define the exact nature of the European Defence Technological and Industrial Base (EDTIB). In reality, there is still as yet no single defence market in Europe. This is despite the fact that successive rounds of consolidation have led to the creation of so-called 'European champions' such as Airbus and/or MBDA Missile Systems. In today's Europe, defence markets are still largely national and they are concentrated in a few countries such as France, Germany, Italy, Spain, Sweden and the United Kingdom (UK). A number of other countries such as Austria, Belgium, Czech Republic, Finland, Greece, Poland, Portugal and the Netherlands also maintain certain elements of a defence industrial base. The rule still seems to be that defence spending takes place on a purely national basis. According to the European Defence Agency (EDA), in 2015 about 82% of equipment spending and 92.2% of Research and Technology (R&T) investment occurred on a national basis (European Defence Agency, 2017). Yet major European collaborative programmes have still been possible to initiate. There is the example of the Eurofighter (Germany, Spain and the UK), the FREMM frigate (France and Italy), the NH90 helicopter (multiple countries) and the A400M transport aircraft (multiple countries).

Cooperation in bilateral and minilateral formats have produced mixed results, but none have been advanced through an European Union (EU) framework. The tendency towards national priorities has led to a number of structural problems in the European defence market related to international competition and military redundancies and costs.

Let us first consider the market aspects. In 2015, European industries achieved a €222 billion turnover representing a sector breakdown of civil aeronautics (51%), land and naval (24%), military aeronautics (22%) and space (3%). Close to 848,000 people are directly employed in the sector in Europe (ASD Europe, 2017). Although defence spending has started to rise in the EU mainly following the actions of Russia in Ukraine, the EU still experiences duplication and waste. For example, the European Parliament estimates that if EU Member States were to cooperate further in defence-industrial matters they could save up to €26 billion per year (European Parliament, 2017). The European Commission have drawn attention to the costs of duplication. In the EU there are 17 different types of main battle tanks (MBT), in the United States (US) just 1. In the EU there are 29 different types of destroyers and frigates, in the US only 4. In the EU there are 20 variants of fighter planes, but there are only 6 types in the US (European Commission, 2017a).

In addition to these costs and duplications is the EU's geopolitical outlook. It is no secret that Europe is experiencing a sustained deterioration in its security landscape. Threats on the southern and eastern neighbourhoods pose challenges such as nuclear and conventional threats (Russia), migration, terrorism (Sahel), energy insecurity and hybrid threats.

The EU also faces questions of unity. 'Brexit' is the most severe case that poses huge challenges for Europe's defence markets. One must also consider the shifting nature of the transatlantic relationship. As the *EU Global Strategy* makes clear, Europe has no real option but to strive for its own strategic autonomy in security and defence (EU Global Strategy, 2016). A major question driving policy in Brussels today is: can the EU fully rely on the security bargain that has emerged since 1945 and what more can the Union do for itself? 'Strategic autonomy', a term that has traditionally made some Member States weary, increasingly seems to drive forward EU cooperation on defence.

The EU is no stranger to shaping the European defence market, for in 2009 the European Commission developed legislation on defence procurement (directive 2009/81/EC) and intra-EU defence transfers (directive 2009/43/EC). In the past year or so, however, the EU has launched a Coordinated Annual Review on Defence (CARD), a European Defence Fund (EDF) and Permanent Structured Cooperation (PESCO). Since the British decision to leave the EU, the bulk of the remaining members have seized on a 'window of opportunity' to move forward on defence-industrial cooperation. Initiatives such as Coordinated Annual Review on Defence (CARD), European Defence Fund (EDF) and Permanent Structured Cooperation (PESCO) were all adopted in the space of about a year having in previous years and decades not developed defence-industrial policy very far. This paper reflects on the recent efforts by the EU to support the EDTIB and it concludes with some thoughts on the challenges facing the EU and the European defence market. The paper is structured in three major parts: (1) an overview of recent initiatives on EU defence; (2) the latest developments designed to turn these visions into action; and (3) a conclusion that outlines some strategic elements for the EU to consider in the future.

What is the EU's Role?

Coordinated Annual Review on Defence

Despite the existence of NATO, a number of European countries have in recent months decided to advance their defence-industrial cooperation through the EU. This began on 14 November 2016 with the creation of the CARD. Initially conceived of as a 'European semester on defence' (to mirror the EU's economic policy equivalent), the CARD is designed to ensure that individual national defence plans are coordinated at the EU level. EU Member States recognised that there is a need to 'deepen defence cooperation and ensure more optimal use, including coherence, of defence spending plans' (Council of the EU, 2016). Planning for defence on a purely national basis, while maintaining some notion of sovereignty, has led to the types of duplication and costs mentioned in the introduction to this paper. Under CARD, the idea is for national defence planners to share information with fellow EU Member States on their budgetary planning cycles and future capability/

technology plans. Once this information is shared, it is thought that the CARD can help EU Member States identify common capability shortfalls, potential areas of joint capability development and future collaboration on defence research.

Therefore, if the *EU Global Strategy* called for the ‘gradual synchronisation and mutual adaptation of national defence planning cycles and capability development practices’, the CARD is the mechanism designed to meet these objectives (EU Global Strategy, 2016, pp. 20-21). As the ‘CARD secretariat’, the EDA will be expected to report to EU defence ministers on a biennial basis. However, CARD will be a voluntary – Member State-driven – mechanism. As the Council conclusions of 6 March 2017 make clear, CARD will not entail a one-size-fits-all approach to defence planning but provide ‘a better overview at EU level of issues such as defence spending and national investment as well as defence research efforts’ (Council of the EU, 2017). This, of course, poses some challenges for the EU as voluntary approaches to defence cooperation have underperformed in the past. For example, in 2007 the EDA Member States agreed to voluntary and collective defence benchmarks on defence spending, R&T investment and European collaboration that have not consistently been met in the past. A key question is whether a voluntary CARD can overcome past behaviour on defence cooperation on the part of the EU Member States.

European Defence Fund

A second major initiative developed by the EU since 2016 is the EDF. The Fund is designed to use the EU budget to support defence research and capability development. Although still in an early stage, there are presently two preparatory elements to the defence fund. First, for defence research to be secured as a fully-fledged ‘European Defence Research Programme’ (EDRP) after 2020 (when the new EU budget cycle begins), the European Commission has initiated a ‘Preparatory Action on Defence Research’ (PADR). For the years up to 2020, the PADR has a budgetary allocation of €90 million – the EU will cover up to 100% of the eligible costs of defence research financed under the PADR. After 2020, it is hoped that an EDRP can secure €500 million per year. The PADR has already started funding defence research programmes at the EU level. In 2017, an initial call for proposals under PADR received 24 concrete proposals involving almost 190 entities such as firms and research institutes.

With a budget of €25 million in 2017 (the overall €90 million up to 2020 is divided into yearly amounts), the EU is presently funding defence research projects on strategic technology foresight (a project led an Italian firm); maritime surveillance and interdiction (involving firms and research institutes Estonia, France, Greece, Italy, Lithuania, the Netherlands, Portugal, Spain, Sweden and the United Kingdom); adaptive camouflage for soldiers (involving firms from France, Germany, Lithua-

nia, the Netherlands, Portugal and Sweden); complex data and communication soldier systems (involving Germany, Italy, the Netherlands, Poland, Portugal, Spain and Sweden); and, finally, protective soldier clothing (involving Finland, Italy, the Netherlands, Portugal and Spain).

The EDF also seeks to fund capability development programmes. This part of the fund is less developed in terms of concrete funding programmes. Whereas PADR prepares the ground for an EDRP after 2020, a European Defence Industrial Development Programme (EDIDP) will set the ground work for a fully-fledged capability fund post-2020 by investing €500 million into EU capability development from 2019-2020. The EDIDP is currently working its way through the EU's legislative process – the European Commission have prepared a draft Regulation on the EDIDP and the Council of the EU and the European Parliament have provided their feedback. The institutions have now met on three occasions during the first half of 2018 to discuss the final regulation. Unlike the PADR/EDRP, which are financed up to 100% of eligible costs, the EDIDP and eventual capability window will only have an eligible cost ceiling of 20% of EU funding. This means that the remaining 80% of funding for capability development should still come from the Member States. Post-2020, it is assumed that the EU will invest €1 billion per year into capability development and this should have a minimum leveraging effect of €5 billion per year when Member State contributions are combined.

There is as yet no clear definition on what capabilities the EU will support under the EDIDP. All one does know at present is the approach and objective of the European Commission and what they want to achieve vis-à-vis the EDTIB. In fact, the legal basis for the EDIDP is Article 173 of the Lisbon Treaty and it clearly states that: “The Union and the Member States shall ensure that the conditions necessary for the competitiveness of the Union’s industry exist. For that purpose, in accordance with a system of open and competitive markets, their action shall be aimed at: speeding up the adjustment of industry to structural changes; encouraging an environment favourable to initiative and to the development of undertakings throughout the Union, particularly small and medium-sized undertakings; encouraging an environment favourable to cooperation between undertakings; and fostering better exploitation of the industrial potential of policies of innovation, research and technological development”. The overarching rationale, therefore, is clearly to improve the competitiveness of Europe’s defence market.

Permanent Structured Cooperation

Another major breakthrough on EU defence-industrial policy in 2017 was the initiation of PESCO, which is an ‘ambitious, binding and inclusive’ framework aimed at incentivising cooperation among Member States in the field of defence capability development and operations. Accordingly, the 25 Member States that have joined

PESCO have accepted 20 commitments and are (in smaller groups of Member States) part of a first wave of 17 capability projects. The aim of PESCO is to raise defence spending in a concerted manner, develop military capabilities jointly, and make their military assets available for operations. Joining PESCO is voluntary. Activities carried out in the framework of PESCO can have either a capability or an operational dimension. Both commitments and projects will be the object of regular assessment by the High Representative for the Union's Foreign and Security Policy / Vice-President of the European Commission (HR/VP) with the support of the EDA and the European External Action Service (EEAS). The industry-related PESCO commitments include: regularly increasing defence budgets in real terms and increased defence investment and research expenditure; involvement in the EDF to increase joint capability projects; and to fill capability shortcomings, plus many more.

In terms of the PESCO projects, a first wave of 17 projects has been identified in 2018 and they are designed to promote cross-border cooperation between EU Member States. The projects in phase one include: a European Medical Command (9 Member States); European Secure Software Defined Radio (8); Network of Logistic Hubs in Europe and Support to Operations (13); Military Mobility (24); EU Training Mission Competence Centre (13); European Training Certification Centre for European Armies (2); Energy Operational Function (4); Deployable Military Disaster Relief Capability Package (5); Maritime (semi-Autonomous) Systems for Mine Countermeasures (6); Harbour and Maritime Surveillance and Protection (4); Upgrade of Maritime Surveillance (7); Cyber Threats and Incident Response Information Sharing Platform (7); Cyber Rapid Response Teams and Mutual Assistance in Cyber Security (7); Strategic Command and Control (C2) System for CSDP Missions and Operations (4); Armoured Infantry Fighting Vehicle/Amphibious Assault Vehicle/Light Armoured Vehicle (3); Indirect Fire Support (EuroArtillery – 2); and EUFOR Crisis Response Operation Core (5).

Compared with previous EU efforts in the defence domain, the added-value of PESCO comes from the combination of the nature of commitments that Member States will make, the accountability that the framework creates for Member States and the permanence of the framework. Taken together, these elements are supposed to shape national mindsets and practices, and in the end the form of cooperation, in a way never observed in the past. PESCO is supposed to lead to greater capability cooperation and industrial synchronisation. Although not all of the PESCO projects currently have an industrial/capability development dimension, this is the start of a process that should lead to the identification and development of new capabilities for the EU. It should also be stated that the European Defence Fund may also be instrumentalised to support capability development within PESCO. For example, the European Commission have stated that the 20% of eligible costs that they will

cover under the EDIDP/capability fund could eventually be increased to 30% for projects placed within PESCO.

Challenges on the Horizon?

The initiatives outlined above mark in many ways a quantum shift in the way the EU deals with defence-industrial issues and the EDTIB. There remain a number of questions, however, about the CARD, the EDF and PESCO. First, for PESCO there are questions about how far the Member States will adhere to the 20 binding commitments made to one another. PESCO is based on an annual review but there is no automatic sanctioning mechanism for states that do not meet their commitments, except for other Member States agreeing to exclude a Member State/s from PESCO. This is unlikely to happen when political considerations are kept in mind. Given the known challenges associated with capability development initiatives outside of the EU framework, there is a need to ensure that the EDF and PESCO do not fall prey to the same pitfalls. Clearly, EDF and PESCO capability projects should meet the objectives of CSDP and European defence more broadly, but there is a need to ensure that capability programmes are sufficiently ambitious to stimulate the buy-in of ministries of defence and industry (even if PESCO and the EDF are not designed to subsidise ongoing capability development projects). Capability development is a long-term process spanning multiple years and decades, and so success through EDF/PESCO has to be measured with this in mind. Achieving a mutually reinforcing relationship between PESCO, the EDF and CARD is still a work in progress.

Second, it will be crucial to achieve industry buy-in to the EDF. The European defence market is built on a complex defence supply chain that is comprised of a range of private, semi-private and public primes, midcaps and small and medium enterprises (SMEs). If the European Commission is ambitious about the types of defence capability projects that could be launched under the 'capability window' of the EDF, then the European defence supply chain as a whole may likely have to buy into the financial incentives on offer too. It will be critical to get primes, midcaps and SMEs on board, but the question is how to do so across borders in Europe. Member States that have a relatively small defence industry might be interested in the EDF for their SMEs, but EDF projects will require more than SMEs and midcaps if the EU is to develop truly ambitious defence capabilities. Prime firms will be needed to develop high-value systems, but the challenge here is that many of these firms still see governments as the major customers and investors in the defence sector. The challenge facing the European Commission is thus two-fold: first, how to stop the EDF being seen as a subsidy for SMEs in smaller Member States; and second, how to ensure that EDF projects do not just benefit prime firms in the larger Member States. This will be a delicate balance to achieve.

Finally, there is another challenge related to the use of the EU budget for defence capability development and support to the defence supply chain. To put it rather candidly, the EU budget is built on contributions from every EU Member State, but the 'capability window' appears to be geared to projects taken up by only a handful of willing Member States. This begs the question: can a common resource such as the EU budget be used to support the needs of a handful of EU Member States?

This could be a test of solidarity and indicate how far Member States view investments made through the EDF, with EU budget support, as a common public good for the whole of the EU. Here, one needs to keep in mind that national parliaments and ministries of defence will also have a say on how the EDF is used. This challenge may even invite some creative thinking as to how capabilities that are eventually developed under the EDF could be pooled, loaned, or utilised by the whole of the EU at some point. This is especially true in a PESCO context.

Conclusion

This paper has outlined recent efforts by the EU to support the EDTIB. The paper provided an overview of recent initiatives on EU defence and the latest developments designed to turn these visions into action. The paper has also considered some (non-exhaustive) strategic elements and questions for the EU to consider. What is clear with EDF, CARD and PESCO is that EU Member States do finally seem to understand that EU defence cooperation is a good way of ensuring the competitiveness of Europe's defence industry and capability development in the future. Yet, as signaled at the start of this paper it is unclear how – in the short term at least – EU Member States are willing to give up their national prerogatives in favour of a single European defence market. We are still at an early stage in developments, but the EDF and PESCO in particular are configured to rely heavily on the political will of Member States. Without Member States – who will ultimately develop and use military capabilities – the EDF and PESCO cannot be a success. The impact of these initiatives on the EDTIB is still unclear – the truth is it is too early to say –, but there is great promise in the efforts taken by the EU.

The EU has achieved much in putting forward the idea for an EDF, CARD and PESCO. As a policy response to the need to push European defence-industrial cooperation to the next level, the EU institutions and Member States have devised a range of innovative policy initiatives. Although financial incentives have been used in national defence procurement processes for many years, using financial incentives at the EU level is new and exciting terrain. The challenges ahead are myriad including: how will a balanced EDTIB be achieved? How will industry buy into the EDF/PESCO? How will the EDF transition from defence research to capability development? What are the capability development priorities?

Much depends on the EU Member States and whether they seize on the incentives put on the table by the European Commission. While it is up to the Member States to politically engage with the EDF, CARD and PESCO, the EU can in the meantime continue to stoke industry's interest but also listen to their specific needs. The task of thinking about what defence capabilities the EU should prioritise begins in earnest.

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