



The EU finally opens up the European defence market

By Clara Marina O'Donnell

- ★ For decades Europeans have been fighting side by side within NATO, the UN, and more recently the EU. Yet European governments have maintained a broadly national approach when purchasing their military equipment. The fragmentation of European defence markets has not only proved unnecessarily expensive but also hampered the ability of European militaries to work together on international missions.
- ★ The EU has agreed a series of reforms aimed at increasing competition in European defence procurement, and at allowing defence goods to move more freely within the EU. As a result, the defence industry should become more competitive and deliver equipment more cheaply.
- ★ The impact of these reforms will depend on how much member-states are willing to use the new tools at their disposal, and to what extent the European Commission is willing to challenge non-compliance by EU governments.
- ★ Over the next few years, EU governments will have to ensure that their efforts to liberalise the defence market do not provoke an unintentional fall in research and development in the defence sector. They must ensure that the European Defence Agency and the European Commission's simultaneous efforts to increase competition do not create confusion. And they should encourage the US to reform its export controls to EU member-states.

Over recent decades, European countries have increasingly sought to act together in foreign policy and defence. Within NATO, and more recently within the EU, governments have developed a shared analysis of global threats, and they have committed themselves to responding to those threats together. European soldiers and policemen have been deployed side-by-side in numerous missions under the auspices of the EU, NATO and the UN in places ranging from the Balkans to Congo and Afghanistan. Several smaller European countries no longer envisage undertaking military operations outside a multinational framework.

Yet until now European governments have usually continued buying their defence equipment on their own and from their own national suppliers. As a result European defence markets continue to be organised broadly along national lines. The regulatory frameworks for defence procurement across the EU have long ceased to be appropriate for

today's world. They are unnecessarily costly and hamper multinational military operations.

Each EU member-state has its own complex regulations governing procurement and exports of defence goods, and most defence procurement is not open to foreign or domestic competition. As a result, defence firms have not been able to benefit from the economies of scale that larger markets would provide. The fragmentation of the market has also led to wasteful duplication. Altogether, EU countries currently have 89 different weapons programmes, while the US, whose defence budget is more than twice the size of the EU's defence budgets combined, has only 27.

Europe's defence companies – which operate increasingly across borders – have struggled with the complicated and diverging national requirements for exports. For example, many member-states require individual authorisations for each defence-related

export, even when the same item (such as a spare part) is sent to the same firm within the EU. So every time a multinational company wants to ship components from one of its plants to another one in a different member-state it has to ask for a new licence. Although such requests are hardly ever rejected, they can take several weeks to process. Worse still, company staff based in different EU countries often need individual authorisations to talk over the phone. The European Commission estimates that the total cost of these barriers amount to over €3 billion a year.

Most member-states also require individual export authorisations every time they sell military equipment to a defence ministry in another member-state. This entails unnecessary and perverse delays. For example, France and Italy have been using French-built armoured vehicles in their contributions to the UN's mission in Lebanon. When a vehicle owned by French troops breaks down, they can get a new part from the manufacturer in France within days. But if the Italian troops need a spare part, the French manufacturer has to ask for an export authorisation. As a result, Italian troops have to wait several weeks for the export licence to be processed. Broken down or badly working equipment can endanger European troops abroad.

In recent years, European governments have realised that the current system is not cost-effective. In 2007, member-states acknowledged that “a fully adequate [defence industrial base] is no longer sustainable on a strictly national basis – and that we must therefore press on with developing a truly European [industrial base].”¹ So EU governments have agreed to open up their defence markets and co-operate with the EU institutions in an area which they had hitherto jealously guarded as a national preserve. This paper assesses the potential impact of the various reforms, and addresses the challenges ahead.

¹ *European Defence Agency, 'A strategy for the European defence technological and industrial base', May 14th 2007.*

EU reforms in the defence market

For 50 years, defence-related goods have remained largely exempt from the EU's internal market rules. EU countries agreed in 1958 that European rules on competition and the free movement of goods should not apply to military and security when “essential security interests” were at stake (a provision now known as article 296 of the Treaty establishing the European Community).

In principle, member-states were only supposed to use the exemption on an exceptional basis, and justify why competitive procurement would pose a security threat. But article 296 carries no definition of the scope of an essential security interest. Consequently, many governments have regarded article 296 as an

automatic exemption. They routinely exclude competition from the procurement of even the most non-sensitive defence goods – including helmets, uniforms and military catering. ‘National security’ has often been a cloak for protectionism.

In theory, the European Commission could have challenged such abuse of article 296 and brought member governments before the European Court of Justice. But the Commission has been wary of pushing too hard in an area that many governments see as central to national sovereignty. Over the last 20 years there have been less than 10 court cases relating to article 296.

The EU took the first step to prise open the European defence market in 2005. Member-states committed to open a substantial amount of their defence procurement to European competition through a voluntary code of conduct. Within the framework of the European Defence Agency (EDA), 22 EU governments agreed to advertise most of their procurement opportunities on a public Electronic Bulletin Board, and to justify any decision not to do so to fellow member-states.²

² *By 2008, 25 member-states and Norway had signed up to the code.*

The next big steps to open the defence market took place at the end of 2008 and early 2009, when EU governments agreed on a directive on defence procurement and another on intra-EU arms transfers. The transfers directive aims to simplify procedures to move military goods amongst member-states. It will require all member-states to offer general and global licences in addition to individual export licences (until now many member-states have only provided individual authorisations).³ The directive aims to reduce the use of individual export licences. In particular, it will encourage member-states to grant general licences when they authorise weaponry or spare parts to be sent to armed forces in another EU country, or when goods are sent to trustworthy defence companies in the EU as components.

³ *Broadly speaking, goods which benefit from a general licence can move across EU borders without exporters having to ask for specific licences to do so. Global licences are granted to defence companies and allow them to transfer several goods to various recipients.*

The procurement directive has the same objective as the EDA's code of conduct. It aims to increase the amount of defence procurement which is open to competition. But in contrast to the code of conduct, the directive is legally binding. It will offer procurement procedures tailored specifically to defence and security needs so that governments can safely open more of their defence procurement to competition. Ministries of defence will benefit from substantial flexibility and security guarantees. Bidding companies will have to protect classified information, and be able to ensure delivery is always on time, even in times of crisis.

The adoption of these two directives reflects an important cultural shift in the EU. Member-states have accepted new EU legal constraints and a stronger role for the European Commission (which was heavily involved in developing the new directives) in an area that until now they have jealously guarded as their own.

The last important development is the agreement of a code of conduct on so-called offsets. Offsets are side-deals in defence procurement contracts in which the ministry of defence requires some form of compensation from the defence company that has won the contract. For example, governments can ask a defence company to invest in their country, including in non-defence sectors. The code, agreed in October 2008 through the EDA, is due to come into force in July 2009.

EU co-operation on offsets was, until recently, inconceivable. Many offsets distort competition and are therefore illegal under EU law. Yet they are central features of the defence-industrial strategies of many EU member-states. The European Commission has so far ducked this controversial issue. The EDA has adopted a pragmatic approach. Through the code, it tries to manage offsets in order to gradually reduce them, instead of aiming at an outright ban.

The impact on the defence market

Potentially, these different initiatives could bring some significant improvements: fewer offsets would mean less market distortion. More competition in procurement would promote a more efficient industry and better value defence goods, to the benefit of defence ministries and European taxpayers. Easier transfers of defence goods within the EU would help large defence companies with plants and subcontractors in several member-states. Small and medium enterprises (SMEs) would find it easier to break into markets in other member-states. And national militaries would have shorter delays when importing new equipment, as in the case of the Italian troops in Lebanon.

However, how far these reforms will be implemented in practice is another question. There has often been a wide gap between what EU rules say and what member-states do in the defence sector. Some experts and EU officials see these developments as only small steps in the right direction. Defence industry representatives counter that the new arrangements will bring significant change over time. Much will depend on how far member-states choose to play the game – particularly for the code of conduct on procurement and the one on offsets. The impact of the directives will also depend on how far defence companies and the European Commission are willing to challenge non-compliance by member-states.

Will the member-states be called to order?

There is already plenty of evidence that some European defence ministries are still reluctant to open up their defence procurement to more competition. The EDA's Electronic Bulletin Board has had some success since its launch in 2006: over 400 contracts opportunities have been published and over 200 deals have been made – including 59 cross border contracts – worth around €3.25 billion. However, some EU countries insert criteria that favour their national industry while others barely use the board at all.

The extensive discretion that governments will enjoy when implementing the directives will play into the hands of the backsliders. Governments get to choose which military goods are safe for general and global transfer licences, and it is likely that only the least sensitive goods will qualify at the outset. The scope of what constitutes an 'essential security interest' has still not been defined clearly in article 296, so at first member-states are still likely to use, or abuse, the exemption widely. Even when governments resort to the new procurement procedures, they may continue to manipulate the criteria within their contracts to favour national competitors. The economic crisis, and the strain on public finances, could strengthen the incentive for governments to make savings through more competition, but it could just as easily persuade them to protect national industries and domestic jobs.

This is why the readiness of the Commission and industry to challenge abuse will be a determining factor as the new rules come into effect. A few rulings by the European Court of Justice against recalcitrant defence ministries would send a clear signal that governments will be called upon to justify their procurement choices.

It is hard to predict how aggressively the European Commission or companies will pursue legal action. The Commission may feel emboldened by the fact that EU governments managed to agree on the directives. However, in the midst of such a severe economic downturn, the Commission may choose to save its political capital for battling protectionist impulses in other, not quite so sensitive, sectors. Defence companies will also have a natural reluctance to sue a government which may be a source of future contracts.

However, if a company faces the prospect of going out of business because it cannot compete for contracts, it may conclude it has little to lose. So in the long term, the procurement directive could have a serious impact on European defence acquisition, and consequently on the European industrial landscape.

The need for mutual trust on exports

The new rules for intra-EU arms transfers will be a cultural shock for many governments. More

importantly, member-states will have to trust their neighbours to ensure that their defence goods are not re-exported to undesirable destinations. That trust does not yet exist across the whole of the EU. Some member-states, such as Germany and the UK, are known to have very reliable export controls. But other countries suffer from lower standards, in particular some of the new member-states such as Romania and Bulgaria. (The UK is the only country in the EU to provide a general licence for the export of

⁴ *The UK excludes Cyprus for political reasons relating to the dispute between Turkey and Cyprus.*

equipment to the armed forces of other member-states, but it has made an exception for Bulgaria and Cyprus.)⁴

The risk of undesirable re-exports was a key concern during the negotiations of the directive, and as a result it contains several confidence-building measures. Notably, defence companies that want to import goods benefiting from a general licence will have to be certified by their governments. The directive lists the general criteria for certification, but the details will be decided by each member-state.

The success of the new transfers system will depend on how effectively EU governments set up the certification process and to what extent they improve their export controls. If member-states do not consider export controls to be thorough across the EU, they will issue general and global licences for only a limited range of goods – or perhaps none at all. So during the forthcoming two-year implementation phase, member-states must work together and share best practice. They should work with the EDA, which has extensive experience in getting member-states to share best practice in defence matters. In addition, the European Commission, which will have to make an assessment of member-states' implementation after two years, must dare to criticise member-states that fall short.

Future challenges: The impact on R&D

Implementation is not the only challenge that the EU faces as a result of its defence market reforms. Some large defence companies are seriously concerned about the impact of the defence procurement directive on research and development (R&D) budgets. Under the directive, government R&D funds can remain exempt from competition, but the production of any good which results from this funding will have to be opened to European competition. Some people in the industry fear that if governments cannot guarantee that the products created by their R&D will be produced domestically, they will be more reluctant to invest. European governments believe that these concerns are overstated, and privately some defence firms admit the same.

Many research areas will not be affected (for instance when R&D is spent on a multinational programme or when it relates to contracts exempt under article 296).

And the directive gives governments substantial flexibility when choosing how to combine their research and production. Nevertheless member-states must ensure that the new directive does not unintentionally lead to a fall in public R&D investment. R&D budgets in Europe are already disconcertingly low (indeed as a share of defence spending, R&D is six times higher in the US than in Europe) and they risk falling further as a result of the budgetary pressures created by the economic crisis.

EDA vs. European Commission

The EU will also have to deal with a challenge posed by its own institutions. So far European governments have been using two different approaches to liberalise the defence market: one based on law, with the European Commission; and the other based on pragmatic arrangements, centred around the EDA. This duality raises a number of questions. Will the defence procurement directive make the EDA's bulletin board redundant? Will they co-exist? In addition there are potential conflicts. The EDA allows member-states to discuss offsets, but according to EU law offsets are often illegal. At what point will the Commission take a member-state to court for resorting to an illegal offset?

As long as different approaches based on contradictory rationales co-exist on the European defence market, there will be confusion and uncertainty. The EDA should be used as a temporary solution to increase trust and transparency amongst member-states, in order to pave the way for the application of EU law in the long-term.

Transatlantic dimension

Finally, as the EU gets serious about opening its defence market, it must not forget the increasingly globalised nature of this industry. The EU should maintain the non-protectionist approach it has adopted so far, and it should also try to use some of its reforms to strengthen trade relations with the world's largest defence market, the US.

Both the EDA code of conduct and the procurement directive make clear that member-states are free to open up their contracts to competition from non-EU countries. Thus US firms, which are important suppliers in many EU countries, will not suffer discrimination. Some protectionist pressures were evident during the negotiations on the procurement directive but, commendably, these were eventually rejected. Because of the relatively limited size of European defence budgets, European industry relies largely on exports to survive. Increasingly, defence companies, such as Finmeccanica and BAE, are looking to the US as one of their key markets. If member-states tried to protect the European defence market, they would only harm their own firms.

The EU should also use its new intra-EU transfers system to encourage the US to loosen its strict export controls to and within Europe. In order to prevent US military technology leaking into the wrong hands, Washington imposes burdensome controls when US-made military equipment and components are re-exported, including between EU member-states. Restrictions apply even for bolts or rubber hoses designed for military aircraft. European governments and industry on both sides of the Atlantic have been calling for the US to reform its unnecessarily costly export controls for years – to little avail. So far the US has not even granted the UK, its closest ally, more lenient controls. (Although there are hopes that a bilateral UK-US deal on looser export controls will finally be ratified by the US senate in 2009.)

If the EU developed an efficient and thorough transfers system, the EU and the US could subsequently harmonise certain aspects of their export controls. For example, they could establish a common certification process for major defence companies. Thorough pan-European export controls could also encourage the US to explore bilateral deals with various member-states and, hopefully over the next decade, make the US amenable to introducing more flexible export controls for goods moving within the EU as a whole.

Conclusion

The EU's recent initiatives to open up the European defence market – the procurement and transfers directives in particular – have the potential to make a real change to defence procurement over the next decade. The impact, however, will depend on how EU governments implement the new rules. To ensure a significant impact, member-states must do all they can to build mutual trust in the run-up to the implementation of the intra-EU transfers directive. And the European Commission should be prepared

to tackle defence ministries that continue to use unfair means to protect their national defence industry from competition, by taking them to the European Court of Justice.

The reforms to the EU defence market will allow EU governments to make better use of their defence budgets and they will strengthen the European defence industry. But they will not be enough by themselves to reverse the decline in the industry's fortunes. Falling defence budgets across Europe over the last 20 years, combined with the spiralling costs of equipment, have put serious pressure on Europe's defence industry. If Europeans want to maintain a world-class industrial base, they will have to take other actions too – for example, increase the proportion of defence budgets devoted to acquisition and R&D, and do more of their procurement collectively.

EU member-states have identified many of the right solutions and they have repeatedly committed to spend their limited defence budgets in a more effective fashion. However, so far governments have been slow to follow up their commitments with actions. They must start doing so now. Otherwise Europe's defence industry will continue to wither. European firms will lack the technology to compete in the US market, and increasingly risk losing contracts to US firms within European markets. Both sides of the Atlantic would suffer. The US would not be able to benefit from lower prices created by transatlantic competition, while Europe's ability to act independently would be compromised. European governments should use the global economic crisis, and the strain on public finances, as the badly needed catalyst to rationalise the European defence market.

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