

#14

DEPLOYING FINANCIAL TOOLS IN SUPPORT OF EUROPEAN DEFENCE COOPERATION

BY

Guillaume DE LA BROSSE /

Adviser, European Political Strategy Centre, European Commission

March 2017

*The views expressed here are solely those of the authors.
They do not reflect the views of any organization.*

Comment

ABSTRACT

Much was said but little was done: European defence cooperation is not at the level it should be. Over 80% of national procurement is run on a national basis, dramatically impacting the European ability to act together. With its Action Plan on European Defence adopted on 30th November 2016, the Commission has deployed a set of incentives that have the potential to re-boost European defence cooperation. It is now up to Member States to act upon the European Union's (EU) incentives, bearing in mind the rapidly changing environment and the need to build a genuinely European strategic autonomy.

INTRODUCTION: BRUSSELS IS MOVING

Together, Member States spend EUR 200 billion a year in defence, making Europe the second most powerful defence player after the United States (US). Yet the sum of 28 defence budgets can hardly be described as a defence strategy that is genuinely European.

- The level of European cooperation remains very low: since 2010, over 80% of defence procurement and 90% of defence research and technology are run on a national basis.
- Europe has a high level of fragmentation in weapon equipment compared to the US, culminating at around 180 different types of equipment against 30 for the latter. This includes 29 types of frigates vs 4 in the US; 17 types of battle tanks vs 1 in the US; 20 types of fighter planes vs 6 in the US (McKinsey, 2017).
- The lack of cooperation also leads to redundant structures between Member States. Up to 30% of annual defence expenditures could be saved through pooling of procurement (McKinsey, 2017). More than 50% of defence expenditure is captured by personnel costs vs less than 40% in the US.

Over the last decade, defence cooperation has been established by political leaders as a means to offset national cuts in defence: "The Council stressed the need to turn the financial crisis and its impact on national defence budgets into an opportunity to give a new impetus to European military capability development" (Council of the EU, 2010). Yet despite several bottom-up initiatives undertaken by the European Defence Agency (EDA), including "Pooling and Sharing", or top-down initiative such as the Policy

Framework for systematic and long term cooperation (Council of the EU, 2014), European defence cooperation never took off within defence establishments.

What are the lessons to be learned from the past decade? Financial austerity did not make defence cooperation more appealing. In fact, it did the opposite: it weakened the case for defence cooperation. When put under financial pressure, Defence Ministries sought to protect national procurement and national industries rather than thinking beyond borders. Political pressure was not sufficient to counter this trend. Continuous top-down guidance of Heads of states and government (European Councils of December 2013 and December 2015) and of Defence Ministers had a limited impact on the daily business of the defence establishments. Likewise, loose coordination and the intergovernmental instruments in place did not manage to anchor defence cooperation as a central tenet of national planning.

The European Defence Action Plan, welcomed by the European Council on 15th December 2016, could potentially inject a new dynamic and structurally reverse the trend towards the re-nationalisation of defence policies (Barnier, 2016). It suggests EU financial incentives, both EU budget and EU financial engineering, as a central leverage for more cooperative programmes, directed towards both Member States and defence industries.

What are the main incentives suggested in the Action Plan and what are their desired effects?

UPLIFTING COLLABORATIVE DEFENCE RESEARCH AND TECHNOLOGY

Preparing future cooperative programmes begins with the implementation of collaborative defence research and technology (R&T) – currently at a very critical stage (Mauro & Tomas, 2016).

Over the last decade, defence R&T has been the first target of defence budget cuts, with a decrease of over 20% in nominal terms over the 2008-2014 time period. Such a drastic decrease may potentially lead to two consequences: sub-investment in the preparation of future capabilities, and erosion of the competitiveness of European defence industries, which increasingly rely on technology-transfer in order to access the export market.

Over the same period, the consequences on European collaborative R&T have been even worse. European R&T expenditures were cut by 60%, with less than EUR 200 million

invested EU-wide in 2014, dramatically impacting the joint preparation and programming of future European programmes.

Against this background, the European Defence Action Plan establishes itself as a game changer (Fiott & Bellais, 2016): it proposes a European Defence Research Programme (EDRP) allocating EUR 3.5 billion in European collaborative R&T in the 2021-2027 time period (next financial perspectives). On average, since 2010, EUR 196 million was spent on a yearly basis in European collaborative R&T (European Defence Agency, 2016). Imposing EUR 500 million would more than triple the European collaborative R&T investment each year. The Union would become the largest spender in collective defence R&T in Europe.

What consequences on European defence cooperation can be expected from the European Defence Research Programme?

- Enabling a joint planning of defence R&T priorities. The prospect of EU funding should lead Member States to agree on tangible European R&T priorities and to jointly define strategic technological roadmaps.
- Catalysing the reflection on European technological autonomy. Indeed, part of the EDRP could be allocated to the development of European industrial supply chains in critical disruptive industries, such as artificial intelligence, robotics, cyber. Or it could also be used to reduce excessive European technological dependencies, especially in ITAR related domains, which then constraint export prospects.
- Facilitating European technological and industrial cooperation. The European defence industry will be closely associated upstream in the definition of priorities, and downstream in the implementation of the R&T priorities. The EDRP should facilitate networking between Research and Technology Organisations, open new schemes of cooperation and increase trust - a prerequisite in order to enable natural cross-border supply chains.

MAKING FUTURE EUROPEAN DEFENCE PROGRAMMES ATTRACTIVE

Complementary to the European Defence Research Programme, the EDAP also proposes to catalyse defence cooperation in the development of future military programmes acquisition of equipment, by addressing three critical issues: (i) technological de-risking; (ii) synchronization of national budgets; (iii) size of the market.

- Technological de-risking: the EU budget could serve as an enabler in order to

launch the development phases of future European programmes. The de-risking of future defence programme is critical on a national basis, and even more so on a multilateral basis. The EU budget would not substitute Member States' contributions, but could be used for the technological de-risking of joint programmes: funding of feasibility studies, of potential technological adjustment, or of technologies not initially planned (such as technologies related to air-traffic insertion in the MALE RPAS programme run by Germany, France, Spain and Italy in OCCAR). It could also facilitate the co-funding of industrial prototypes. One option to organize such support could be the use of the art. 185 TFEU with an exclusive focus on European defence programmes (i.e. no EU support to national programme).

- Synchronization of budget planning: if Member States agreed on pooling national resources in a joint fund, and trusted the Commission with the management of the fund on their behalf, the Commission could provide financial engineering services. Such a mechanism would fill a gap: acting as a bank, the Commission would leverage money on capital markets and offer very attractive loans to Member States. This would be a solid step towards increased financial solidarity at a European level. The leverage could benefit Member States participating in cooperative R&D programmes. It would be complementary to ongoing work done by the European Defence Agency on building a Cooperative Funding Mechanism (loan system organized among Member States).
- Potential increase of the market-size: the Commission could also build an attractive business case out of cooperative programmes by expanding the size of the market. First, it could suggest the above mentioned financial engineering services to other Member States willing to buy the equipment. In doing so, the Commission would also contribute to pool the demand, facilitating joint acquisition. In the long run, this would build a genuine European Defence Equipment Market. Second, the Commission could consider patrimonial EU purchases of equipment of dual-use application, such as in the field of strategic transport, cyber-security, or surveillance. Such acquisitions would facilitate the implementation of the mandate of EU executive agencies. This would require a clear process of identification of civilian needs and their injection into the development of the joint equipment of dual use nature.

FACILITATING THE CROSS-BORDER NATURE OF SUPPLY CHAINS

The European Defence Action Plan may also facilitate the execution of cooperative programmes by creating more favourable conditions for the Europeanisation of supply chains.

First, the European Investment Bank (EIB) could facilitate the establishment of European supply chains by providing loans to relevant Midcaps and SMEs. Indeed, such companies do not often receive frontload R&D money from the primes. This means they have to find funds to invest on their own, often large amounts of money and for several months before they deliver products or technologies. Such a system can put Midcaps and SMEs at risk, and can act as a barrier for newcomers. Hence the intervention of the EIB could mitigate such a financial risk.

Second, the EDAP proposes to stimulate the cross-fertilization between internet companies and defence, which should contribute to facilitating the cross-border inclusion of non-traditional suppliers. In addition to building an ecosystem bridging more easily defence industry and civilian innovative industries benefiting from Horizon 2020, consideration should also be given to developing innovative funding scheme at a European level. The latter would support the scaling up of innovative dual-use SMEs and facilitate their inclusion in traditional European defence supply chains. This approach underpins the US Third Offset Strategy, aiming at preparing and securing US future technological superiority.

CONCLUSION – AN ENABLER OR A PLANNING TOOL?

The European Defence Action Plan has the potential to generate a positive business case for defence cooperation, especially when combined with tax-policy incentives, such as VAT exemption granted to *ad hoc* projects run in the framework of the European Defence Agency (European Defence Agency, 2015). Three conditions will have to be met to turn this potential into a real enabler:

1. The buy-in of Defence Ministries. Incentives should be as simple as possible. Getting the political buy-in will not suffice. Experts, in particular in national procurement agencies, should also apprehend European incentives to cooperation in a positive way. This requires that the defence specifics of European defence programmes are not disrupted by excessive conditions imposed by the Commission (especially concerning the industrial setting up and on export policy).

2. A strong legal basis supporting the use of EU budget in support of defence cooperation. There is certainly scope to use the research legal basis of the Treaty (art 179 TFEU) to use EU fund in support of research and development of future European programmes. The role of the Commission as management of a potential intergovernmental fund could potentially rely on the Pringle case (judgment of 27th November 2012), by which "Member States are entitled to entrust tasks to the institutions, outside the framework of the Union, such as the task of (...) managing financial assistance".

3. A dedicated budgetary line in the next financial perspectives (2021-2027). In the current geostrategic context, there are many incentives to build a "1% case". 1% of the future EU budget could be allocated on a yearly basis to European defence cooperation, potentially covering research, development and dual-use acquisition. Of course, this should be part of a broader discussion on the next multiannual financial framework, starting in 2017.

EU financial instruments will have to gain credentials in Defence Ministries, with first pilot cases to be run up to 2021. If the upcoming years lead to a successful outcome and to a stand-alone defence priority in the next EU financial perspectives, EU financial incentives could go beyond generating the European reflex required for future defence programmes.

EU financial incentives could also have further profound and transformative consequences. Beyond incentivizing short term opportunities for defence cooperation, they could also pave the way for a new tangible framework for European Defence Cooperation. Indeed, as of 2021, EU funding would certainly have to come together with robust managing structures. This would open new avenues for European capability *priority-setting, planning tools and framework for defence cooperation*, and would thus channel future European defence funding towards European strategic autonomy. In this context, the upcoming discussion on the Permanent Structured Cooperation and the strategic review of the European Defence Agency could frame some of the features of a future genuine European Defence Cooperation. ■

REFERENCES

Barnier, M. (2016). Vers une union de la défense. *Le Monde {online}*. Available at : http://www.lemonde.fr/idees/article/2016/12/14/michel-barnier-vers-une-union-de-la-defense_5048955_3232.html

Council of the European Union (2014), *Council Conclusions on Common Security and Defence Policy {pdf}*. Available at: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/EN/foraff/145824.pdf

Council of the European Union (2010), *Council Conclusions on Military Capability Development {pdf}*. Available at: https://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/esdp/118348.pdf

European Commission (2016), *State of the Union speech*. Available at: https://ec.europa.eu/priorities/state-union-2016_en

European Commission (2016). *European Defence Action Plan*. Available at: http://europa.eu/rapid/press-release_IP-16-4088_en.htm

European Defence Agency (2016). *Defence data 2014*. Available at: <https://www.eda.europa.eu/docs/default-source/documents/eda-defencedata-2014-final>

European Defence Agency (2015). *Guide to VAT exemption for EDA ad hoc projects and programmes*. Available at: <https://www.eda.europa.eu/info-hub/press-centre/latest-news/2016/04/14/guide-to-vat-exemption-now-available>

Fiott D. and Bellais R. (2016), *A game changer? The EU's Preparatory Action on Defence research {pdf}*. Available at: <http://www.iris-france.org/wp-content/uploads/2016/04/ARES-Group-Policy-Paper-Fiott-and-Bellais-04-16-OK.pdf>

Mauro F. and Tomas K. (2016). *The Future of EU defence research {pdf}*. Available at: [http://www.europarl.europa.eu/RegData/etudes/STUD/2016/535003/EXPO_STU\(2016\)535003_EN.pdf](http://www.europarl.europa.eu/RegData/etudes/STUD/2016/535003/EXPO_STU(2016)535003_EN.pdf)

Mckinsey (2017). *In Munich Security Report 2017: Post-Truth, Post-West, Post-Order?* Available at: <https://www.securityconference.de/en/discussion/munich-security-report/>

#14

Comment

DEPLOYING FINANCIAL TOOLS IN SUPPORT OF EUROPEAN DEFENCE COOPERATION

BY **Guillaume DE LA BROSSE** / Adviser, European Political Strategy Centre, European Commission

March 2017

The views expressed here are solely those of the authors. They do not reflect the views of any organization.

ARES GROUP

The Armament Industry European Research Group (Ares Group) was created in 2016 by The French Institute for International and Strategic Affairs (Iris), who coordinates the Group. The aim of the Ares Group, a high-level network of security and defence specialists across Europe, is to provide a forum to the European armament community, bringing together top defence industrial policy specialists, to encourage fresh strategic thinking in the field, develop innovative policy proposals and conduct studies for public and private actors.

CONTACT [Pilots]:

Jean-Pierre Maulny, Olivier de France, Sylvie Matelly, Sophie Lefeez

ares@iris-france.org

+33 (0)1 53 27 60 60

www.iris-france.org/ares

#AresGroup