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# PROMOTING EUROPEAN DEFENCE COOPERATION AND THE PROMISE OF FINANCIAL INCENTIVES

BY

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*The views expressed here are solely those of the authors.  
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**Comment**

The European Union (EU) has never directly funded defence research or military capability development before; so the fact that EU financial support for both defence research and joint capability development is now possible following the release of the European Defence Action Plan (EDAP) is curious and interesting. The fact that defence research and capability development are now seen as vital strategic investments on behalf of the EU marks a radical shift in the way the EU thinks about and supports defence. Following the release of the EDAP on 30 November 2016 and the unveiling of the European Defence Fund (EDIF<sup>1</sup>), the European Commission outlined how it intends to invest in defence. The fund is comprised of two 'windows'. The first is centred on defence research, and will see the EU allocate €90 million for defence research from 2017 to 2020 out of the EU budget - €25 million of which has already been earmarked for 2017. In time, this 'research window' could be endowed with a €500 million per year allocation, called the European Defence Research Programme (EDRP). If agreed, this programme would be operational from 2020 onwards (Fiott and Bellais, 2016).

The second 'window' within the defence fund focuses on defence capability development. This 'capability window' aims to pool national resources with a view to financing joint capability development projects. Based on how much the European Defence Agency's (EDA) participating member states (pMS) have spent on collaborative equipment projects in the past, the Commission estimates that a reference figure of approximately €5 billion per year for the 'capability window' could be enough to launch various capability projects. From 2010-2014, the EDA's pMS spent an average equivalent amount of €7.56 billion per year on collaborative projects. To encourage member states to actively participate in the 'capability window', the European Commission has innovatively suggested the potential use of a number of financial incentives. The hope is that such incentives could stimulate defence cooperation between European states in ways not seen before. This is new terrain for the EU. It is worth reflecting on the EDIF and whether financial incentives can potentially serve as a 'game changer' for European defence cooperation.

## THE COSTS OF COOPERATION

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The EDAP/EDIF marks an innovative departure from past ways of thinking about defence cooperation in Europe. Under the umbrella of the Common Security and Defence Policy (CSDP), EU member states have worked together to identify and to try to fill military capability gaps (e.g. the Headline Goals and the Capability Development Plan).

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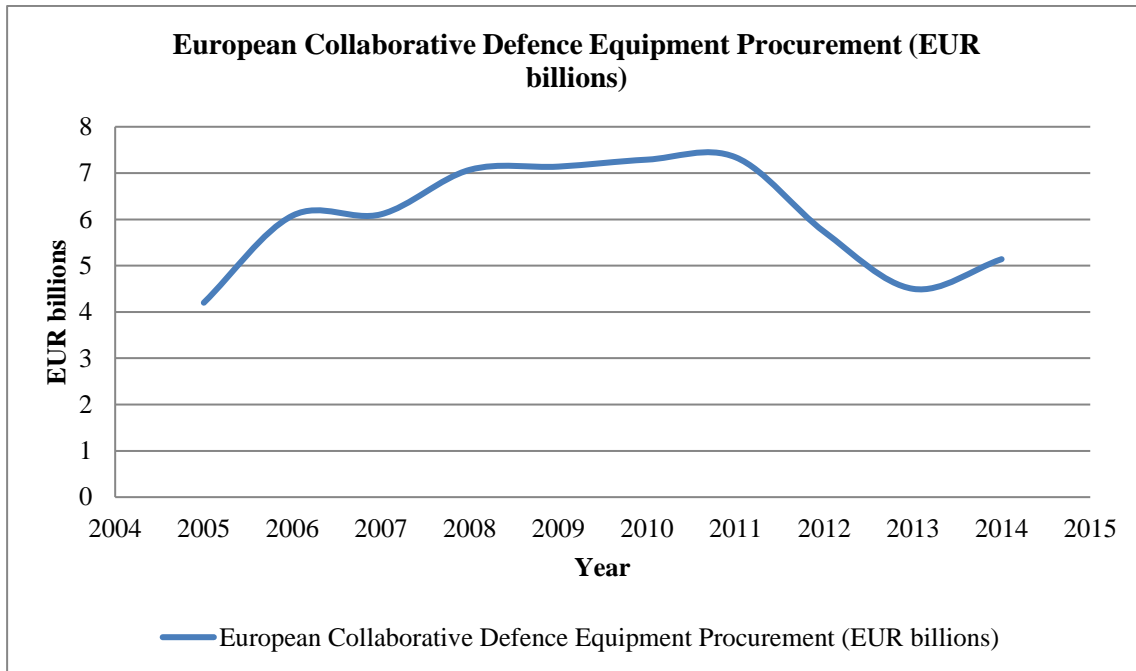
<sup>1</sup> Although the logical acronym would be EDF, this would cause some confusion with the European Development Fund, which already uses the EDF. For the purposes of this paper, EDIF is used - 'I' denotes 'investment'.

Within the EDA, participating member states have gotten used to operating on an intergovernmental and largely voluntary basis to pursue common defence projects (e.g. EDA R&T projects). In some cases, the EDA has itself launched programmes aimed at stimulating cooperation between European governments. Even outside of the EU, European states have engaged in bi- and multi-lateral efforts that are designed to integrate forces, procure capabilities and/or to engage in defence research efforts (e.g. the Lancaster House treaties or Benelux cooperation).

What is notable about these types of working methods is the reliance on intergovernmental agreement, voluntarism and good will between partners. However, the record on defence cooperation is mixed. Multiple studies have pointed to the costs that can afflict cross-border collaborative efforts between a number of partners on any given defence capability project (see Hartley, 2011: 168-182; DeVore, 2011). The costs of cooperation are not to be ignored when thinking about ways to stimulate European defence cooperation, especially in an era of generally flat defence budgets and the escalating costs of defence technologies (Bellais and Fiott, 2017).

As the graph below indicates, despite increased collaborative spending from 2005 to 2011, in 2013 collaborative European spending on defence equipment almost fell back to 2005 levels. Although another uptick in collaborative spending occurred in 2013, it is unclear where European collaborative defence equipment procurement is headed. Here, it is worth reflecting on the fact that these collaborative efforts have occurred within the context of two EU directives agreed to in 2009: one on defence procurement (2009/81/EC) and the other on defence transfers (2009/43/EC). Together, these directives are designed to improve cross-border cooperation in the European defence market. Yet, as the European Commission itself recognises in its recent evaluation of the directives, despite the continued relevance of the directives they are being applied unevenly across the EU and they are largely bypassed for contracts for 'high-value, strategic, complex defence systems'.

All of this begs the question: are EU member states loath to cooperate further with one another because of the perceived costs associated with collaboration? This is a question which has partially driven the thinking behind the EDAP and the EDIF. Because of the pressing strategic and security challenges facing the EU, greater focus on understanding what inhibits European defence cooperation and what policy tools could be used to promote cooperation has been a major intellectual departure point for the European Commission. Legislative mechanisms, such as the EU defence directives, and the EDA's efforts to stimulate defence cooperation, provide for a certain cooperative dynamic that will remain important. However, the European Commission now wants to experiment with new cooperative methods, such as financial incentives.



*Data source: European Defence Agency*

## INCENTIVISING COOPERATION

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Given the costs and challenges associated with European defence cooperation, the European Commission has decided to think in new ways about how precisely to stimulate defence cooperation. When specifically looking at the EDIF, the Commission is focusing on what financial incentives could be used to stimulate, and to possibly lower the costs associated with defence cooperation. The ‘capability window’ of the defence fund will be based on pooled national contributions, and a reference figure of approximately €5 billion per year for the development of collaborative capability projects is foreseen. So far, so good. Member states will be encouraged to participate in the defence fund (De la Brosse, 2017), although it should be noted that the pooling of financial resources for particular projects is not in itself a new method of cooperation. The start-up costs for several past programmes began with similar arrangements.

Therefore, a salient question is how the European Commission can encourage the EU member states to cooperate with one another when it is traditionally challenging to do so. This is where it can be claimed that the EDIF could be a ‘game changer’ in European defence. First, the Commission has explained that when member states pool national capital contributions under the ‘capability window’, they could benefit from a ‘one-off’ discount from their structural fiscal effort under the Stability and Growth Pact (SGP).

Many member states have long argued that spending more on defence is difficult to justify when their responsibilities under the SGP discourages public debt. This highlights the tension between fiscal discipline and investment in security, which has become more acute in the context of a shifting security landscape in and beyond Europe. Although fiscal discipline remains a priority in the EU, the European Commission could permit a ‘one-off’ exemption under the SGP with a view to stimulating European defence cooperation. This is an interesting, if politically sensitive, development in the history of European defence. Providing ‘exemptions’ under the SGP could be seen as a challenge to the principle of fiscal discipline.

Second, in the EDAP the Commission states that it stands ready to ‘explore all financing options from the EU budget’ to support projects under the ‘capability window’. In this respect, one of the possibilities could be to use the EU budget to support demonstrator projects, prototypes, feasibility studies, testing and dual-use products. Crucially, the Commission also states that the administrative expenditure of the ‘capability window’ could be charged to the EU budget. As stated, some studies have argued that European collaboration does not necessarily reduce costs; whereas other studies claim that cost reductions can be made despite the challenges associated with cost overruns, delays and export potential. Either way, the fact that the Commission stands ready to potentially help offset some of the costs associated with collaborative projects may just encourage more European cooperation.

## **MAKING THE INCENTIVES WORK**

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The European Commission is presently undertaking a scoping study on the EDIF to ensure common understanding between the EU member states, to engage with industry, and to ultimately ensure that the EDIF is calibrated to the needs of EU member states and the CSDP. As far as the potential involvement of the European Investment Bank in supporting the European defence supply is concerned, it is perhaps not just a case of consulting defence ministers, but finance ministers too. During this scoping study, a number of questions may emerge that could define the future nature of European defence cooperation. For example, there is a need to think about the configuration of the ‘research’ and ‘capability’ windows in such a way as to ensure an efficient linkage between, on the one hand, the planned EU investments in lower Technology Readiness Levels (TRLs) under the ‘research window’; and, on the other, the higher TRLs associated with some of the potential projects to be launched under the ‘capability window’ (Fiott, 2017). In short, there is a need to fill the gap between the phases of Research & Technology and Research & Development.

Furthermore, it will be crucial to achieve industry buy-in to the EDIF. 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 SMEs. If the European Commission is ambitious about the types of defence capability projects that could be launched under the 'capability window', 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 EDIF for their SMEs, but EDIF 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 EDIF being seen as a subsidy for SMEs in smaller member states; and second, how to ensure that EDIF projects do not just benefit prime firms in the larger member states. This will be a delicate balance to achieve.

However, 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 EDIF, with EU budget support, as a common public good for the whole of the EU. This dilemma may even invite some creative thinking as to how capabilities that are eventually developed under the EDIF could be pooled, loaned, or utilised by the whole of the EU at some point. This debate will evolve over the next few months, especially when one considers that permanent structured cooperation (PeSCo) is now seriously being considered by several member states. How the EDIF and PeSCo could fit together is another open question, especially given that once and if PeSCo is triggered by qualified majority vote, it would then be subject to unanimous decisions. Theoretically at least, PeSCo participants could technically have a veto right over the EDIF should the fund be placed within PeSCo.

Finally, there will be a need to think about how the EDIF sits in relation to the existing legal framework for defence procurement. For example, how would EDIF projects be treated under Directive 2009/81/EC. Indeed, if EDIF projects are considered a form of

international collaboration as described under article 13(c)<sup>2</sup> of the directive, then EDIF projects would be exempt from the purview of the directive. If the directive does not apply to EDIF projects, then in what way can the Commission encourage practices such as subcontracting<sup>3</sup> that could favour a more balanced defence supply in Europe? Furthermore, it is necessary to consider how the EDIF could be regarded in relation to the EU's prohibition on defence offsets. It could be difficult to invest EU funds in defence capability programmes where only a handful of member states and industry are part of the project. The challenge is to set-up the EDIF projects in such a way that EU funds do not become seen as an EU subsidy for particular industries or markets.

## FROM INCENTIVES TO CAPABILITIES...

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The European Commission has achieved much in putting forward the idea for a European Defence Fund. As a policy response to the need to push European defence cooperation to the next level, the Commission has 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: what is the optimal intellectual property right regime for EU defence investments? How will a balanced EDTIB be achieved? How will industry buy into the EDIF? How will the EDIF 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. These incentives show real promise but for now, they are ideas on a piece of paper. The next few months will reveal how these ideas are lifted from the page to a reality where EU member states feel confident to potentially draw on EU budget support and other measures to boost their collective defence efforts. While it is up to the member states to politically engage with the fund, the Commission can in the meantime continue to stoke industry's interest but also listen to their specific needs. Once the modalities of the EDIF become clearer, then the task of thinking about what defence capabilities should be prioritised begins. ■

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<sup>2</sup> Article 13(c) states that the directive shall not apply to: 'contracts awarded in the framework of a cooperative programme based on research and development, conducted jointly by at least two Member States for the development of a new produce and, where applicable, the later phases of all or part of the life-cycle of this product'.

<sup>3</sup> Article 21.4 of Directive 2009/81/EC state that member states can ask or require 'the successful tenderer to subcontract to third parties a share of the contract'. This measure was seen as a way to bring in mid-caps and SMEs into larger product development programmes and therefore support the EDTIB.



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### **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.*

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