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THE 2022 DEFENCE PACKAGE: A USEFUL CONTRIBUTION TO SUPPORT THE EUROPEAN DEFENCE FUND?

Édouard SIMON

SENIOR RESEARCH FELLOW,
THE FRENCH INSTITUTE FOR INTERNATIONAL AND STRATEGIC AFFAIRS (IRIS)

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They do not reflect the views of any organisation.*

Comment

EXECUTIVE SUMMARY

The European Defence Fund is a breakthrough in EU support to defence R&D and is expected to result in capabilities bought by Member States. However, its financial support (and its incentive effect) does not go beyond the prototype phase. The 2022 defence package could usefully focus on the later phases of capability development: industrialisation and acquisition.

Incentivising cooperative industrialisation programmes based on EDF results:

- ⇒ Ways to operationalize the EDA's Cooperative Financial Mechanism (CFM) and to possibly extend it to other countries, especially for the purpose of building upon EDF results, shall be explored as the lack of synchronization of defence budgets is still a major risk for cooperative projects.
- ⇒ The Commission could usefully precise that it will not integrate national contributions to cooperative projects building on EDF results in the calculation of Member States' structural deficit. Such an approach would comply with the Commission appraisal of contributions to EU programmes.
- ⇒ In the context of the forthcoming debate on the reform of the Stability and Growth Pact, the European Commission should ensure that defence-related investments are not by principle or de facto excluded from any specific rule aiming at protecting investment.

Supporting the procurement of capabilities developed and produced in Europe:

Acquisition of capabilities based on EDF results

- ⇒ The promotion of the "Commission notice on guidance on cooperative procurement in the fields of defence and security", which makes explicit the conditions to benefit from exemptions provided by directive 2009/81/EC, appears necessary to make sure that regulation will not be considered as an additional factor of complexity for the launch of acquisition based on EDF results.
- ⇒ The 2022 defence package could usefully explore different options for EU procurement of defence capabilities and launch a debate with Member States on this perspective. C2 and strategic enablers would be promising areas for such common acquisitions.

Pooling and Sharing on the whole life-cycle of capabilities

The 2022 defence package could promote cooperation similar to EATC or the Dutch-Belgian cooperation and launch a reflection on existing means at EU level to support such cooperation.

- ⇒ Waiving VAT for the acquisition of defence equipment developed and produced in Europe" would have the advantage to lay the ground for better level playing field between European and US defence equipment on the Internal market.
- ⇒ Given the relatively disappointing results of the two 2009 directives so far, the 2022 defence package could be the opportunity to announce initiatives (1) to enforce the procurement directive and (2) to further harmonize the content of general transfer licences related to EDF projects. In addition, such initiatives would comply with recent demands from the European Parliament.

Lay the foundations for a consolidated approach of EU defence industrial initiatives

The 2022 defence package should include a commitment to elaborate and publish by 2023 a true European defence industrial strategy that would aim at bringing a more coherent approach to these different initiatives.

Keywords: Defence package, European Commission, European capability development, Incentives, Armament cooperation.

In her latest speech on the State of the European Union¹, on September 15, Ursula von der Leyen underlined the necessity to further improve interoperability among EU Member States and decrease Europe's dependencies to third countries as a step towards a genuine European Defence Union. She notably evoked the necessity to develop “new ways to use all possible synergies” such as, for instance, “waiving VAT when buying defence equipment developed and produced in Europe”.

As a direct consequence, the Commission Work Programme 2022² includes “a defence package which will include a roadmap on security and defence technologies for boosting research, technology development and innovation and reducing the EU's strategic dependencies in critical technologies and value chains in the security and defence sectors”. This new defence package³ should be presented on February 9th.

Beside initiatives related to the monitoring of EU's strategic dependencies, this “package” of new proposed initiatives will have to build upon and complement some major initiatives initiated by the European Commission since 2016 and notably the European Defence Fund. In order to be relevant and a useful step towards a true European Defence Union, these initiatives should usefully focus on one objective: ensuring that capabilities developed thanks to EDF are procured by Member States, especially those which took part in the funding of development actions. Hence, the objective of this paper is to detail initiatives that would bring a true value added and would enable to build upon the European Defence Fund.

THE LIMITS OF THE EUROPEAN DEFENCE FUND

The creation of the European Defence Fund has been a breakthrough for European defence cooperation and in the EU approach to defence markets and industry. Indeed, it is the first time that the EU budget is mobilized to fund specifically defence research and development carried out by European companies and that the European Commission has been entrusted as a major engine for this cooperation.

The European Defence Fund finances research actions in full and development actions only partially. It acts as a top up (sometime significant) to Member States co-funding. However, EDF intervention does not cover later phases of an armament programme (i.e.

¹. 2021 State of the Union Address by President von der Leyen, September 15th 2021.

². European Commission, Commission Work Programme 2022, COM(2021) 645, October 19th 2021.

³. A first defence package had been released by the European Commission in 2007 and included two proposals of directives that were adopted in 2009 (directive 2009/43/EC simplifying terms and conditions of transfers of defence-related products within the Community and directive 2009/81/EC on the coordination of procedures for the award of certain works contracts, supply contracts and service contracts by contracting authorities or entities in the fields of defence and security).

industrialisation and procurement) and, as a consequence, does ensure that Member States will commit to launch a programme based on EDF results. In its first draft of the European Defence Fund⁴, the European Commission proposed the creation of a “flexible Financial Toolbox” to complement the Fund itself.

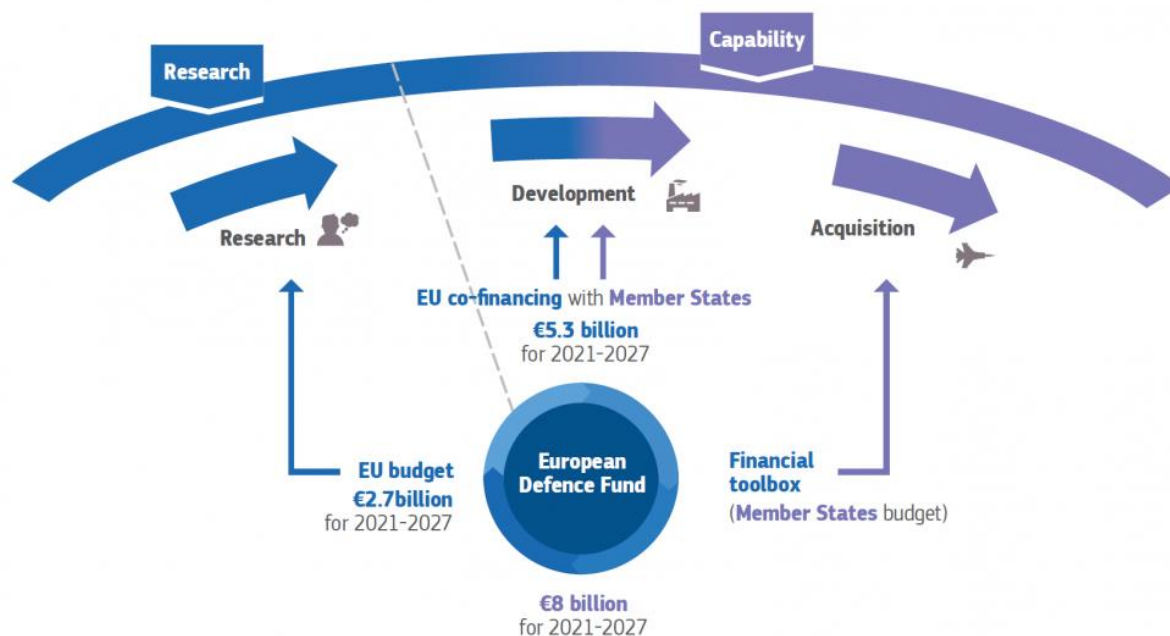


Figure: Structure of the European Defence
Source: European Commission

According to the Commission, such a Toolbox should aim at incentivising Member States to engage in (1) collaborative development programmes after the intervention of the EDF (i.e. after the prototype phase) and (2) joint acquisitions. The basic idea of this proposal was to ensure that technologies and capabilities developed through EDF would meet a demand. Since then, and understandably enough, efforts of the Commission were focused on the adoption of the EDF regulation and on its first wave of calls for projects.

The new defence package could operationalise this flexible Financial Toolbox and secure that capabilities and technologies developed thanks to EDF are procured by Member States. Concretely, it should include new (financial, regulatory, etc.) incentives for cooperation on the industrialisation (post-prototype) and the acquisition phases.

INCENTIVISE COOPERATIVE INDUSTRIALISATION PROGRAMMES BASED ON EDF RESULTS

In order to be relevant, the European Defence Fund needs its results to lead to the development of capabilities, bought by Member States and used by Armed forces. Doing

⁴. European Commission, *Launching the European Defence Fund*, COM (2017) 295, June 7th 2017.

so, it will contribute to EU Strategic autonomy. But EDF support cannot go beyond prototyping, testing, qualification, and certification phases.

Ideally, defence R&D funded through EDF shall lead to collaborative industrialisation programmes. It is a commonplace that cooperative programmes are complex and can be hindered by various and numerous obstacles. In particular, the transition from prototyping to industrialisation is particularly complex and sensitive to handle in cooperative programmes (see, for instance, the Franco-British FCAS project). Those obstacles shall be addressed in order to limit the risk for a cooperative project to derail and ultimately stop.

In its communication “Launching the European Defence Fund”, the Commission identified some of these obstacles⁵ and ways to overcome them. Since then, most of these projects have stalled. One of the most promising initiatives was the Cooperative Financial Mechanism (CFM) promoted and managed by the European Defence Agency. CFM aims at limiting the risks triggered by the lack of synchronization of defence budgets. Such risks prevent a cooperative programme to be launched on time and cause numerous and sometimes significant delays. Even though an agreement has been reached in 2019 on a Programme Arrangement between the 11 participating countries, the CFM has still not entered into force as one of them has still not signed it.

- ⇒ **Ways to operationalize the EDA's Cooperative Financial Mechanism and to possibly extend it to other countries, especially for the purpose of building upon EDF results, shall be explored** as the lack of synchronization of defence budgets is still a major risk for cooperative projects.

Beyond the launch of a project, it appears that budgetary constraints may also hinder the smooth running of a project and even put an end to it. EDA data on defence budgets show that, in the aftermath of the 2008 financial crisis, participating Member States have passed on fiscal consolidation policies primarily to cooperative armaments programmes, to the detriment of stated European objectives and of their common interest. In that context and given that EDF projects are recognised for their added value for the Strategic Autonomy of the EU, it appears that legitimate budgetary constraints stemming from the Stability and Growth Pact do not weigh primarily on cooperative projects contributing to the EU Strategic Autonomy.

- ⇒ **The European Commission could usefully precise that it will not integrate national contributions to cooperative projects building on EDF results in the calculation of Member States' structural deficit.** Such an interpretation would replicate what exist for national contributions to EDF projects and would comply with the spirit of the communication “Making the best use of the flexibility within the existing rules of the Stability and Growth Pact⁶” of the Commission.

⁵. European Commission, *Launching the European Defence Fund*, COM(2017) 295, June 7th 2017.

⁶. European Commission, *Making the best use of the flexibility within the existing rules of the Stability and Growth Pact*, COM(2015) 12, January 13th 2015.

- ⇒ **In the context of the forthcoming debate on the reform of the Stability and Growth Pact, the European Commission should ensure that defence-related investments are not by principle or de facto excluded from any specific rule aiming at protecting investment from fiscal consolidation, especially when they build upon EDF results.**

SUPPORT THE PROCUREMENT OF CAPABILITIES DEVELOPED AND PRODUCED IN EUROPE

A distinction shall be made between (1) incentivising measures aiming at capabilities funded through EDF, (2) similar measures to support pooling and sharing of capabilities and (3) initiatives aiming at ensuring a level playing field on the Internal Market.

Supporting the acquisition of capabilities based on EDF results

In order to make sure that technologies and capabilities which benefited from EDF funding are procured, it may first appear useful to make clear the legal regime to procurements based on EDF results and to clarify any potential doubt.

- ⇒ **The promotion of the “*Commission notice on guidance on cooperative procurement in the fields of defence and security*”⁷, which makes explicit the conditions to benefit from exemptions provided by directive 2009/81/EC, appears necessary** to make sure that regulation will not be considered as an additional factor of complexity for the launch of acquisition based on EDF results.

With the Covid-19 pandemic, national public finances have sometimes significantly worsened. Given the foreseeable increase in pressure on national budgetary policies, opening the debate on the possibility for the EU to directly procure defence capabilities would be beneficial.

- ⇒ **The 2022 defence package could usefully explore different options for EU procurement of defence capabilities and launch a debate with Member States on this perspective.** It would certainly be useful to refer to the most promising areas for such procurements. In this case, C2 and strategic enablers would be natural choices.

Promoting Pooling and Sharing on the whole life-cycle of capabilities

Beyond the industrialisation and acquisition phases, cooperation should also be incentivised on the whole life-cycle of capabilities. Indeed, according to an approximation of the costs related to a capability, its exploitation and its withdrawal represents up to

7. European Commission, *Notice on guidance on cooperative procurement in the fields of defence and security*, 2019/C 157/01, May 8th 2019.

more than 50% of its total cost. Even though this proportion with the type of capabilities considered, exploitation and withdrawal phases are still a significant pool of potential cooperation among Member States.

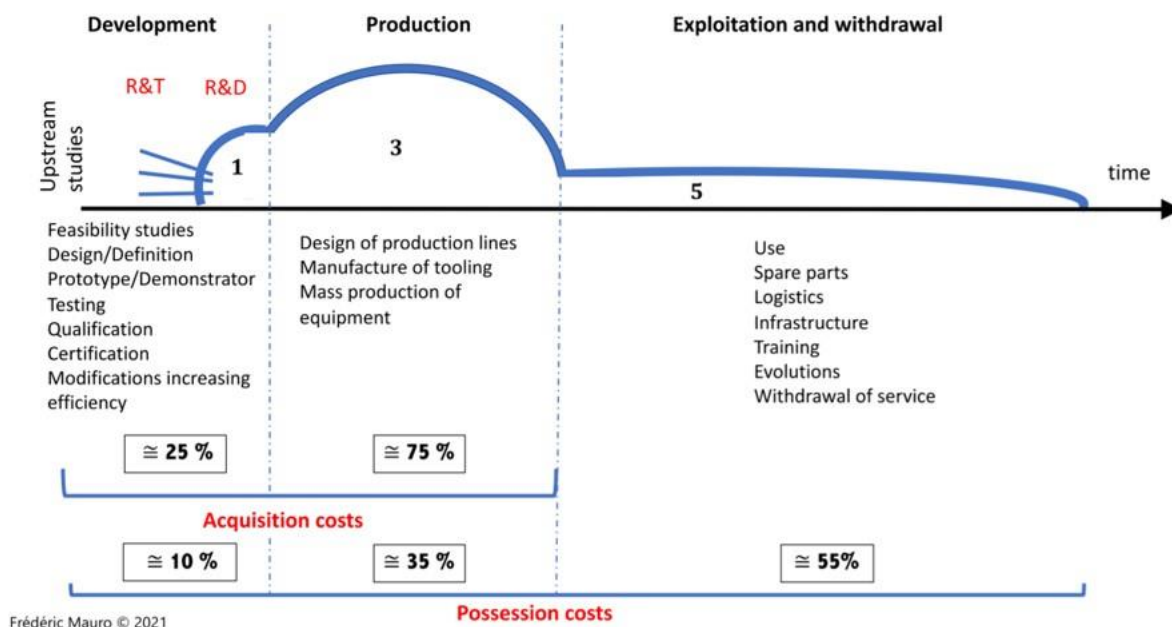


Figure: Approximation of the cost of a capability

Source: Mauro F. & al., *Review of the Preparatory Action on Defence Research (PADR) and European Defence Industrial Development Programme (EDIDP): lessons for the implementation of the European Defence Fund (EDF)*, 2021

A good example of what can be achieved is probably the European Air Transport Command (EATC). A further example, on a bilateral level this time, is the cooperation that exists between the Belgian and Dutch navies, whether in terms of procurement or maintenance. Indeed, the two countries, which are linked by a strategic partnership in the naval domain (the BeNeSam - *Belgisch-Nederlandse Samenwerking* - cooperation agreement), have the same capabilities (minehunters, frigates, and helicopters), are operating them jointly, and share their logistic and maintenance. While Netherlands oversees the maintenance of both countries' frigates, Belgium is responsible for the maintenance of the minehunters, allowing significant economies of scale. A next step towards a full integration of both navies was taken with the ongoing common renewal programme, which foresees the joint procurement of mine countermeasure vessels (a program led by Belgium) and of anti-submarine warfare frigates (a program led by Netherlands).

⇒ **The 2022 defence package could promote similar cooperation and launch a reflection on the necessary means at EU level to support such cooperation.**

A European level playing field for defence equipment

From a general perspective, a discrepancy exists in market access opportunities for European and US defence firms. Consistently with the general objectives of the Internal Market, the Commission shall pursue a greater level playing field for defence equipment. For instance, the US law prohibits the taxation of US assistance provided under Foreign Operations, Export financing, and related programs appropriations act(s). It includes Foreign Military Sales (FMS) - the main vector for US defence equipment exports. In addition, the NATO Support and Procurement Agency (NSPA) enjoys a similar VAT exemption for the acquisitions it supervises on behalf of participating Allies. EDA's VAT exemption appears to be much more restrictive in its conditions and cannot be considered as equivalent.

⇒ **Waiving VAT for the acquisition of defence equipment developed and produced in Europe, as evoked by Ursula von der Leyen, would have the advantage to lay the ground for better level playing field between European and US defence equipment.**

In the end, ensuring market opportunities for EDF-funded capabilities and technologies raises the question of the existence of a truly European Internal Market for defence products – which was the main focus of the 2007 defence package.

⇒ **Given the relatively disappointing results of the two 2009 directives so far, the 2022 defence package could be the opportunity to announce initiatives (1) to enforce the procurement directive and (2) to further harmonize the content of general transfer licences related to EDF projects.** In addition, such initiatives would comply with recent demands from the European Parliament⁸.

LAY THE FOUNDATIONS FOR A CONSOLIDATED APPROACH OF EU DEFENCE INDUSTRIAL INITIATIVES

Eventually, this 2022 defence package shall be used as the first phase of a longer-term reflection on European Defence industry. Indeed, since 2016, many initiatives have been launched that impact defence technological and industrial bases, both at EU and national levels. This package should normally include other initiatives focusing on EU defence industry. And the Strategic Compass, if it will probably not include direct provisions on industrial matters, will necessarily have implications for defence industry. At least, it is

⁸. European Parliament, Resolution on the implementation of Directive 2009/81/EC, concerning procurement in the fields of defence and security, and of Directive 2009/43/EC, concerning the transfer of defence-related products, 2019/2204(INI), 25 March 2021.

expected to impact the EU capability development initiatives in order to enhance their effectiveness.

Such a multiplication of initiatives raises the question of their consistency and bears the risk of dilution of EU efforts and budget. The latest EU defence industrial strategy is the European Defence Action Plan and dates back to 2016 (i.e. before the adoption of the European Defence Fund or massive changes in the European geopolitical context).

The 2022 defence package should include a commitment to elaborate and publish by 2023 a true European defence industrial strategy that would aim at bringing a more coherent approach to these different initiatives. ■

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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.

CONTACT [Pilots]:

Jean-Pierre Maulny, Édouard Simon, Olivier de France, Sylvie Matelly

ares@iris-france.org

+33 (0)1 53 27 60 60

www.iris-france.org/ares

#AresGroup