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**COMMUNICATION FROM THE COMMISSION TO THE COUNCIL, THE
EUROPEAN PARLIAMENT AND THE EUROPEAN ECONOMIC AND SOCIAL
COMMITTEE AND THE COMMITTEE OF THE REGIONS**

**A STRATEGY FOR A STRONGER AND MORE COMPETITIVE EUROPEAN
DEFENCE INDUSTRY**

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1. INTRODUCTION

Europe's defence industry has an annual turnover of over €55 billion. It accounts for around 30% of world production and has more than 300 000 employees. Twenty years ago, real turnover and employment were almost twice as high. Since the end of the Cold War, defence strategies have been reviewed, European armed forces have been remodelled and defence expenditure reduced.

A strong defence technological and industrial base (DTIB) in Europe remains a fundamental underpinning of the European Security and Defence Policy (ESDP). The ESDP is designed to provide the EU with the capacity for autonomous action in order to respond to international crises, without prejudice to actions by NATO. The DTIB produces the capabilities needed not only to meet global defence, but emerging security, challenges. Only a competitive DTIB can provide Europe with autonomy, affordability and the ability to cooperate internationally in the development and production of defence equipment.

Europe has several companies that are competitive at both the EU and global level and provide world-leading capabilities in many market segments. Its industry also has the potential to produce all the capabilities needed to meet global challenges and provide forces acting on the EU's behalf around the world with the high performance equipment and systems they need. A key task is to clearly define the capabilities that Europe's armed forces need to meet these challenges and in co-operation with the EU Military Committee, the European Defence Agency (EDA) is developing a Capability Development Plan to identify priorities for capability needs and development.

The defence sector is a technology-intensive sector whose cutting-edge research and development creates a spill-over in other areas. Defence is interlinked with electronics, information and communications technologies, transport, biotechnology and nanotechnology. Together, these industries constitute a source of opportunity, innovation and know-how which spurs development and growth throughout the economy.

Moreover, many new technologies developed for defence have also turned into drivers for growth in civil sectors such as global positioning, the internet and earth observation. Increasingly this is becoming a two-way process as civil sectors contribute to the defence (e.g. development of software). This growing cross-fertilisation is important for Europe's Lisbon Strategy for Growth and Jobs.

Furthermore, the sector is becoming more difficult to define as the boundaries between defence, security and civil technologies (e.g. electronics, telecommunications) are becoming less fixed. Peacekeeping/making missions and the impact of terrorism, have led to a blurring of lines between internal and external security and to a need for better policy co-ordination between both.

However, there are clear signs that Europe's defence industry is being held back by an inadequate policy and legal framework. A recent European Parliament publication¹ demonstrated the high cost of 'non-Europe' with different national regulations, licensing

¹ "The Cost of Non-Europe in the Area of Security and Defence"

procedures, export control lists, lack of information sharing, etc. This creates red tape, duplication, hampers innovation, increases prices and is detrimental to competitiveness.

This Communication presents a "Strategy for a stronger and more competitive European Defence Industry". It recognises the special character of the industry and its unique relationship with governments but argues that much can be done to unleash its full potential to ensure that it provides value for money to Member States and delivers the capabilities needed in an efficient and effective manner for the ESDP.

2. DEVELOPMENTS IN THE DEFENCE INDUSTRY MARKET

Governments dominate the sector through a variety of roles such as regulators, owners, controlling shareholders, funders of R&D and as principal customers. However, many other parties are involved in setting the policy and regulatory framework within which the industry must operate. Defence and security policies are determined by the European Union, NATO and individual Member States. The regulatory framework is shaped by Treaty requirements, Community policies and Member States. The EDA, in which the Member States and the Commission work together, aims to support the Council and Member States in their effort to improve European defence capabilities, and to foster the European DTIB.

2.1. Financial conditions

National defence budgets are the main determinant affecting the prospects of the defence industry. These budgets reflect national policies and priorities and, over the last 20 years following the end of the Cold War (as a 'peace dividend'), they have halved (from 3.5 % of GDP in the 1980s to a current average of 1.75%) leading to a reduction in turnover and employment. According to the EDA², **overall defence spending in Europe appears unlikely to increase**. Investment in research and technology, development and procurement occupies a much smaller proportion of the total defence budget in Europe than in the United States. At the same time, **costs for military equipment have risen and armed forces have been restructured making the drive to improve competitiveness and achieve value for money even more important**.

While in the past a few Member States could afford to maintain a comprehensive defence technological and industrial base, national defence budgets in isolation can no longer finance the development of a full range of top quality products and new national defence programmes have become less frequent.

The decrease in defence expenditure in Europe also has had an effect on investment in research and technology. While the US defence budget is about twice as large as that of all European defence budgets combined, it devotes some 35% of its total budget to investment compared to only about 20% in Europe and it outspends Europe by six to one in defence R&D. Moreover, R&D investment in Europe is fragmented, leading to duplication and waste of scarce resources.

² Long-term vision – A perspective on industry, endorsed by the EDA Steering Board in September 2006

2.2. Fragmentation of the market

Although defence production is concentrated in six Member States (Germany, Spain, France, Italy, Sweden and the United Kingdom), companies producing ancillary equipment and systems can be found all over Europe. However, on average, Member States spend almost 85% of their equipment budget domestically.

European governments have a clear **preference for their own national defence industries** not only to protect jobs and boost investment but also to ensure security of supply and of information. Member States are reluctant to accept mutual dependence. As a consequence, producers from other Member States have only limited, or no, access to domestic defence markets. This results in a lot of duplication which can be seen in the total of 89 different weapon programmes in the EU compared to only 27 in the US.

Furthermore, Article 296 allows Member States to be exempt from internal market rules for national security reasons. In particular, Member States are not obliged to supply information the disclosure of which they consider contrary to their essential security interests, and they may take measures related to "the production of or trade in arms, munitions and war material" which are necessary for the protection of the essential interests of their security. However such measures may not "adversely affect the conditions of competition in the common market regarding products which are not intended for specifically military purposes".

Domestic markets for defence industry goods are fragmented in Europe through:

- Member States making extensive use of Article 296 to **exempt defence contracts from EU procurement rules** even though the Court of Justice has stated that the use of the exemption should be limited to exceptional, clearly defined and individually justified cases.
- National systems to **control transfers of defence equipment** inside the EU which do not distinguish between exports to third countries and transfers between Member States. This results in unnecessary red tape costing business over €400 million a year. Such high costs further limit market opportunities for competitive SME subcontractors in other Member States.
- Legislation on **control of strategic defence assets**, which some Member States have refined in recent years (e.g. UK in 2002; DE in 2004 and FR in 2005) and which often does not take account of the European dimension.
- Infrequent and *ad hoc* cooperation and coordination among Member States on the definition of requirements, R&D or common production programmes. The result of setting **defence requirements** from a national perspective is further exacerbated by using non-harmonised **standards** which hamper cooperation in R&D and production programmes.
- The distortion created by **offset requirements** (compensation orders) which many Member States still impose in connection with defence procurement. Although they are often said to help sustain defence spending, and to some extent reflect weaknesses in the present structure of the European defence industry and markets, there is a danger that buying states are less concerned about the competitiveness of the product than the attractiveness of the proposed offsets.

2.3. External markets

European governments are not restricted in their choice of trading partners for defence. This means that, despite the clear domestic preference, a significant part of Europe's defence equipment is imported, especially from the US. While most European markets are open to US manufacturers, European producers often find a closed door when trying to export their defence goods to the US. This makes it more difficult for European defence industries to spread costs and maintain and develop their design expertise.

2.4. Conclusion

Improving long-term competitiveness is crucial for the European defence industry and for Europe's security and defence ambitions. Further industrial adaptation should aim at greater specialisation leading to a more integrated supply chain and competitive European DTIB.

So far defence industry adaptation has mainly taken place on a national basis. Although there have been some successful cross-border mergers within the EU, most European cooperation has tended to take the form of joint programmes or ventures which have a limited impact on improving competitiveness. This has slowed consolidation, specialisation, modernisation and restructuring in Europe's defence industry and limited the freeing up of capital to be used more productively elsewhere in the economy.

As industry continues to adapt to infrequent new defence programmes and relatively low research and investment expenditures, it will become more costly to maintain production capacity and, strategically more importantly, R&D facilities in Europe. Capital is already migrating in search of better returns on investments in the US and elsewhere.

This approach is no longer sustainable if Europe wishes to retain a vibrant and substantial DTIB. With unchanged policies the European industry risks becoming a niche player, supplying mostly non-European prime contractors, thereby jeopardising the industrial capacities to autonomously develop the capabilities needed for the ESDP.

A dynamic strategy is needed to improve Europe's existing disjointed approach to the defence industry. A strategy that increases the competitiveness of the defence industry, prepares it for future challenges, promotes its capacity for innovation, preserves and creates more high quality jobs and further develops its current strengths.

3. POLICY MEASURES TO STRENGTHEN EUROPE'S DEFENCE INDUSTRY MARKET

In this chapter **a broad range of policy measures** is presented on which the Commission will continue to work closely and effectively with its partners, and particularly the EDA, to ensure the best outcome. These measures are designed to improve overall coordination, strengthen the internal market for defence goods, and help the adjustment and modernisation process necessary in Europe.

3.1. Policies to improve the functioning of the internal market for defence products

3.1.1. *New legislation*

For the Commission, improving the functioning of the internal market for defence products is a priority. This Communication is therefore accompanied by a proposal for a directive on

intra-EU transfers of defence products and for a directive on defence procurement. The purpose of both these proposals is to contribute to the progressive establishment of a European Defence Equipment Market (EDEM); where suppliers established in one Member State can serve, without restrictions, all Member States. These proposals provide an essential framework for the establishment of a more competitive and stronger defence industry and should be implemented as soon as possible.

The proposal for a **directive on intra-EU transfers of defence products** will facilitate transfers by eliminating unnecessary paperwork. EU Governments procuring from suppliers established in another Member State will see their security of supply improved. By significantly reducing licence application costs, and by allowing system integrators to open their supply chains in more predictable conditions, the new rules will increase opportunities for competitive Small and Medium-sized Enterprises (SMEs) to supply components or sub-systems thereby contributing to making the European market more dynamic.

The proposed **directive on defence procurement** will enhance openness and competitiveness of defence markets in the EU taking into account specific features, such as security of supply and security of information. It will reduce the regulatory patchwork in this field. It will increase competition and transparency and so aid SMEs to find, and bid for, sub-contracts. By providing new rules applicable to the procurement of arms, munitions and war material and to certain sensitive non-military security items, this initiative should further limit the use of Article 296 to exceptional cases as stipulated by the Court of Justice and build upon earlier steps taken by the Commission³ and the EDA to encourage greater openness of defence markets.

3.1.2. Other measures

The functioning of the EDEM can be further improved by minimising other **obstacles to defence industry market integration**.

The Commission will **promote the use of common standards** to facilitate the opening up of defence markets. The Commission brought together stakeholders to develop a “Defence Standardisation Handbook” and is working with the EDA to encourage its use. **It calls on Member States to make full use of the Handbook in their defence procurement.**

The effectiveness of the new directive on intra-EU transfers, and the defence procurement directive would be enhanced by **greater mutual confidence among Member States**. For this, a common regime of appropriate guarantees, backed up by verification possibilities, both in terms of technology financing and in terms of delivery is necessary. Such a regime for stable security of supply and industrial information may have to be built progressively, beginning with those Member States who are already prepared to accept mutual dependence, but working towards a scheme eventually covering all Member States. Starting in 2008 the Commission will **investigate, in close cooperation with Member States, possibilities for an EU system on security of information** that would allow exchange of sensitive information between Member States and European companies. This exercise will consider the potential scope, contents and form of such a system.

³ COM(2006) 779

The current **patchwork of national legislation on control of strategic defence assets** prevents consolidation, the removal of duplication and the development of more efficient industries. It could also prove ill-suited in the future in **securing the control of assets in a more European supply chain**. Clearly, it is necessary to strike a balance between freedom of investment and protection of security interests regarding control of material and other assets that are considered essential. The Commission will start, in 2008, with a **study defining how control of assets might be undertaken in the future** to ensure competitive supply at the European level. This will consider the range of options available to Europe to sustain its essential defence and security interests.

The Commission will continue to use, as necessary, the relevant Treaty provisions and legal instruments at its disposal to **ensure fair competition** for defence industry goods and to avoid distortions of competition on non military markets.

- From an economic perspective, all **offsets** can distort the functioning of markets and hamper the integration of Europe's defence markets. Therefore, the ultimate aim is to create the market conditions, and the European DTIB structure, in which the practice will no longer be needed, taking care that the competitive position of European enterprises compared to third country suppliers is not impaired.
- A progressive opening of the market with improved security of supply between Member States and suitable procurement rules applicable throughout the EU will increase transparency and should reduce the need to use Article 296. However, in the context of establishing open markets, it becomes even more **important that a level playing field is ensured**. Therefore, aids to defence industries should be made fully transparent if the necessary mutual confidence is to be established.

3.2. Policies to improve overall coordination

Member States must shoulder their responsibilities to collectively provide the ESDP with the industrial and technological tools it needs. While military capability is a matter for Member States, they could seek the best level of performance through sharing and pooling the resources of European civil and military programmes, drawing on multiple use technology and common standards, to allow for more cost-effective solutions.

3.2.1. Pooling of demand

A **permanent exchange of ideas on defence planning and investment** is therefore required. This implies that Member States be more transparent with each other, and are willing to concentrate on fewer activities than today by focusing on centres of excellence which should emerge from a primarily market-driven process. Given the long timescales for R&D, product life and in-service upgrades in defence, **alignment of procurement timing by Member States is a necessary first step** to coordinate demand. The EDA is currently working on ways to address this issue. Additionally, providing mutual transparency among Member States on their medium to long-term defence planning, would allow opportunities to be identified for joint investment projects, pooled acquisitions and coherent role specialisation. The EDA has already started **collecting information on Member States' defence expenditure to create more possibilities for coordination of investment and pooling of demand**. This evolution could also lead to the definition of European co-operation programmes such as those presently implemented by the 'Organisme Conjoint de Coopération en matière d'Armement' (OCCAR).

3.2.2. Pooling of R&D investment

Europe is currently spending less than 5% of its government defence budgets on R&D⁴. An **increase in the proportion of defence spending devoted to R&D would improve competitiveness** by spurring the innovative capacity of Europe's defence industry. At the same time, it makes sense to find ways to **pool research and network resources** at all levels - political, industrial and scientific - in the defence area. This is particularly important given the impact of collaborative research on later convergence in markets.

Researchers in defence are developing technologies that are often similar to their civil counterparts in the stages prior to the development of specific applications. To avoid unnecessary duplication, and taking account of requirements and policy priorities for civil security and defence which may differ, it would be useful to systematically identify **synergies between research and development programmes**, for example, between the security research programme of FP7 and the defence-related research activities envisaged, or coordinated, by the EDA.

Additionally, a **European Security Research and Innovation Forum (ESRIF)** was launched in September 2007. It will present in 2009 a Joint Security Research Agenda providing guidance for security research programming on European and national levels. ESRIF will also enhance the public-private channels of communication in the field of European security research and increase transparency and coordination between the various ongoing programmes and initiatives.

3.2.3. Strengthen the position of SMEs

The actions outlined in 3.1.1, **will themselves strengthen the position of SMEs**. Specific provisions have also been introduced to encourage SME participation in the 7th Framework Programme for Research in the security thematic research area and through the 'Research for the benefit of SMEs' initiative including, raising the maximum reimbursement rate for SMEs from 50% to 75% and introducing simplified participation rules. To assist SMEs to find and exploit market opportunities, **the EDA developed a Code of Best Practice in the supply chain (CoBPSC) and an "e-portal"** as a complement to the Code of Conduct on defence procurement⁵. The Commission will closely follow implementation of the EDA CoBPSC and, once adopted, of the Directive on Defence Procurement.

3.3. Accompanying policies

The measures presented above will contribute to Europe's defence industry's competitiveness, resulting in more cooperation, specialisation and innovation. More competitive markets will lead to the emergence of stronger companies, creating new high quality jobs.

3.3.1. Opening up foreign markets

A strong, competitive European defence industry should also benefit from **economic opportunities outside the EU**. While noting the possible impact of different national export policies, bigger sales in third markets would increase profitability and the return on investments in R&D, production facilities and human capital. At the moment, the European

⁴ €bn out of a total budget of €193bn in 2005 for EU24

⁵ <http://www.eda.europa.eu/ebbweb/>

defence industry is effectively excluded from supplying the US market except through US-based facilities as a result of regulations to safeguard national security, "Buy American" defence provisions and other measures. Thus the **European defence industry finds it hard to benefit from economic opportunities in the US** while on the other hand, US companies have easier access to European markets.

For Europe to improve its market access in the US, it is important to **ensure the European defence industry can match its competitors in the US in terms of innovation and quality**. A more European approach to cooperation at home is the first step in reducing European technological dependency. In particular, joint action **to identify and develop key technologies and industrial capabilities and secure them** for the EU would greatly enhance credibility and reduce the burden of ITAR (International Traffic in Arms Regulations) restrictions.

The importance of the US market should not divert attention from the potential new challenges and opportunities stemming from the rapidly emerging economies and the potential re-emergence of other major competitors. To ensure that European companies benefit from these economic opportunities, acting within the framework of the EU Code of Conduct for Arms Exports, the **Commission recently presented a renewed market access strategy in emerging economies**⁶. Under this initiative, the Commission will address the key barriers to Defence markets abroad identified in the Market Access Database.

3.3.2. Managing change

Anticipation and management of change and restructuring are integral to industrial policy. While an industry that succeeds in addressing market challenges will create new opportunities and benefits, there could still be some **adjustment costs, including job losses, in specific regions and/or categories of workers**.

The potential economic and social consequences of further market integration in the defence sector should be addressed by an active Social Dialogue facilitating the management of change and restructuring. Several of the reforms adopted under the 2005 State Aid Action Plan concerning, among other things, regional and training aid, can also assist in anticipating and addressing structural change as can the structural funds and the European Social Fund in particular.

3.3.3. Improving European defence industry market governance

The creation of **the EDA** confirmed Europe's intention to offer an effective framework for the promotion and enhancement of armaments cooperation and the development of defence capabilities.

The Commission's membership of the EDA Steering Board recognises its role in this sensitive domain and provides a solid base for coordination arrangements between various actions. Moreover, the EDA and the Commission share a common diagnosis: the EU needs a competitive defence industry which in turn needs a European market.

The full potential of the EU can only be exploited if there is effective co-operation between all interested parties. The solution lies in a structured dialogue with the competent

⁶ COM(2007) 183

bodies of the Member States, within the EU Second Pillar and the EDA, within the framework of the existing attribution of competences, to optimise synergies between all aspects of policy affecting the defence industry's competitiveness.

In this regard, the EU should have at its disposal an appropriate mechanism **available** ensuring, at a European level, a reflection on **challenges and key issues in security and defence including industrial competitiveness, taking into account existing national expertise, e.g. think tanks**. The **Commission will explore the best means to achieve this** with all interested parties.

4. CONCLUSION

The time has come to take vigorous action to enhance the competitiveness of Europe's defence industries. Simply put, if we remain on the current path, European citizens will continue to pay too much and receive too little in terms of their defence and security and Europe's defence industry will lose its competitive edge.

The strategy presented in this Communication will create better conditions for Europe's defence industry to prepare for future challenges by increasing its competitiveness, promoting innovation, and building upon existing strengths, creating a fairer market place, and preserving and creating high quality jobs. This strategy is designed to ensure that Europe's defence industry can deliver the best capabilities for the ESDP.

Member States, EDA and the Commission must take the necessary actions, both individually and collectively, to promote coordination of an overall policy to strengthen the internal market for the European defence industry. This Communication outlines the Commission's contribution to this shared objective.