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DEFENCE PROCUREMENT IN THE EUROPEAN UNION

Introduction

Despite considerable efforts to integrate, or at least co-ordinate, defence procurement in the European Union, progress has been modest. Although some initiatives have been developed recently, the prospects for a common defence procurement policy remain remote. At the political level, the Western European Armaments Group (WEAG) brings together most EU NATO members in an effort to harmonise arms procurement and discuss co-operation, but with limited results. More recently, two initiatives have been launched by smaller groups of countries in pursuit of closer co-operation in arms procurement. The Organisation for Joint Armament Co-operation (OCCAR) and the Letter of Intent (LoI) both enjoy legal status, and recent years have seen a degree of success, particularly in the form of the first entirely new OCCAR programme on the Airbus A400M. However, most armament procurement is still driven by the member states, and much of it subject to offset provisions. Taken together, these developments add up to significant changes in European arms procurement co-operation, at least compared to the slow pace of developments up to the late 1990s, even if progress can hardly be described as more than modest. Although efforts to establish a European Armaments Agency are underway, there is still a long way to go before Europe has anything like a common armaments policy.

The challenges inherent in developing EU co-operation on defence procurement are related to the very nature of European integration. First, the EU is a predominantly civilian organisation. Second, it is made up of member states with widely differing public policies and procurement practices, not to say policy preferences, security concerns and priorities. Third, European integration has taken the form of a range of functional

organisations. This is particularly the case with defence and national security, where efforts to incorporate defence into the EU system failed in the 1950s and the extent to which the EU should address matters related to defence and security remains controversial. However, as in other areas of European integration, industry change (in this case cross-border mergers and acquisitions) is providing an additional driving force behind integration.

Defence Exemptions in a Civilian European Union

Not only is the EU primarily a civilian organisation, but explicit provisions have been made for possible exclusion of defence products from its scope. Article 296 of the EU Treaty (formerly 223) provides exemptions for armament procurement and defence products from rules on competition and free movement. Despite efforts by some member states and the European Commission to have this exemption removed, it remains. This is more because of national economic interest than national security. The key reason is the historical symbiosis between defence firms and the state, which has clearly limited the scope for EU policy. Moreover, foreign and security issues were outside the EU framework until the Single European Act integrated European Political Co-operation in to the EU. With the success of the Common Foreign and Defence Policy (CFSP), the Article 296 exemption makes little military sense, and defence procurement could be seen as a logical part of the Single Market rather than defence and security. This logic has of course only been reinforced by the move towards a common European Security and Defence Policy (ESDP), and the 1998 UK-France St. Malo declaration's call for a common defence capacity supported by strong technology. Moreover, the increasing importance of 'dual use' (i.e. both military and civilian) products in military hard- and software, the relevance of this to Research & Development policy and the need for European standardisation of equipment due to common military activities has allowed the Commission some room for initiatives in the field.

Article 296 represents a classic case of regulatory capture by industry. Although several states, including the Netherlands and Sweden, oppose the principle of offset provisions,

whereby defence imports are balanced by purchases by the exporter from the importing country's defence (or civilian) industry, none is prepared to abandon this practice unilaterally. Even if this would make sense in terms of economic theories of trade as well as more cost-effective procurement, domestic defence industry provides strong opposition to unilaterally renouncing offset. Arguments are usually cast in terms of industrial policy, employment and maintaining technological competence. Yet positions vary considerably from state to state. For instance, the Dutch defence industry is opposed to offset, unlike that in many other European countries. However, even where industry opposes the principle of offset, typically expecting to gain from free trade, specific protection is often supported as a necessary evil.

Policy Making and Accommodation in a Plural Regime

Negotiating and implementing agreements among the EU member states is exacerbated by the plural nature of the regime. The EU is a plural regime in the sense that it is made up of member states that differ not only in terms of language, culture and policy preferences, but also in terms of administrative systems. Even when there is agreement on goals it does not follow that the means are uncontroversial. In the case of defence procurement, central questions include states' different industry structures, differences in private and state ownership and approaches to the appropriate role of state intervention in industry, as well as security procedures. Efforts to design a common system for arms procurement therefore face the challenge of combining several different national administrative systems and patterns of procurement.

The EU member states feature a range of industrial policies that are not fully compatible, either with each other or with the Single European Market. The result has been that policy making in sectors that the state considers of vital interest (or hold a large stake) is often characterised incremental change. Compromises accommodate differences at the cost of coherence. The defence sector is no exception. Defence procurement initiatives reflect and accommodate the European Commission's efforts to create a single market as well as the states preferences. These comprise more liberal states' orientation toward free

trade and some small states' expectations that their increasingly specialised industry may benefit from integration, as well as defence of protected industry in states like France and Spain.

European Integration and Defence Procurement in a Multi-Organisation System

Finally European integration is a pluralist project, based on the EU and a raft of institutions that are tied to the EU in various ways and with differing degrees of overlapping membership. All EU states except Ireland are members of the West European Armaments Group, which also includes all European NATO members except Iceland. This remains the most significant initiative. Smaller groups of states have recently joined together in initiatives for closer co-operation and harmonisation, but so far the effects have been rather limited. Apart from the EU, key organisations include

- WEAG and WEAO – the Western European Armaments Group and Western European Armaments Organisation, a broad forum for co-operation on arms procurement
- OCCAR – the Organisation for Joint Armaments Co-operation, a joint procurement agency established by the 'big four' (UK, France, Germany and Italy)
- LoI – the Letter of Intent, and accord between the big four and Spain and Sweden to ease export restrictions pertaining to defence procurement

Over the last two decades European integration has brought about closer ties between the civilian and military arrangements, to the extent that much of the West European Union's functions are integrated and are being taken over by the EU. So far, however, arms procurement has remained exempted from EU rules, although the Commission and several national governments are pushing for changes. Two parallel developments stand out: the Commission's effort to expand its competencies gradually to cover more of the defence sector, and the larger states' efforts to replace case-by-case offset arrangements with longer-term arrangements designed to yield a 'fair' return in terms of procurement and production. In addition to efforts to remove Article 296, the Commission's initiatives include strengthening Research and Development (R&D) and standardisation,

both of which will permit it to extend the single market into the defence sector. In this context, it is beginning to question states' application of article 296. The big four states' initiatives (OCCAR and LoI) represent an effort to transcend offset without giving up a degree of intervention and protection of their national industries. The smaller states tend to be somewhat more sceptical of the benefits of these arrangements.

The Evolution of European Defence Procurement Co-operation: The Tortuous path towards a European Armaments Agency.

The West European Union remains at the centre of European efforts to integrate arms procurement and develop a common armaments policy. Although most of the WEU's work has been transferred to the EU, collective defence (Article 5) remains under WEU, and the WEU Secretariat, the Assembly and WEAG have been maintained under somewhat uncertain transitional arrangements. The question of complete integration of the remainder of the WEU into the EU should be raised at the 2004 Intergovernmental Conference (IGC). WEAG is therefore attached to the WEU Secretariat in Brussels, and continues to operate after the transfer of most WEU activities to the EU, remaining the only forum for discussing armaments policy that includes almost all European NATO and EU states (Iceland and Ireland are not members).

The main obstacles to and drivers behind change in European armaments policy are related to the national governments, technological change, the role of the European Commission and the evolution of the European defence industry.

Industrial Policy

National protection of industry and concerns that defence spending should contribute to the national economy are the main obstacles to defence procurement integration. This comes in the form of policy preferences as well as institutional obstacles to integration. The need to generate political consensus and public support for defence spending has

prompted most states to link defence procurement to general industrial policy, and to use it to enhance demand for domestic industrial produce. Hence the offset provisions, which require domestic industry to deliver civil or military products to the foreign supplier (or, in some cases, government) for, typically, the total amount of the sum spent on procurement in the case of foreign contracts. In other words, domestic industry benefits even from defence procurement abroad. These problems related to institutional and procedural differences among member states, as well as by differences between more *dirigiste* states (France) and states where private industry dominates (Germany, UK), or smaller countries with highly specialised industry (Sweden, the Netherlands). Therefore, despite cost-driven pressure for more efficient arms procurement, integration is problematic. Even where there is political will, wide differences make it difficult to reach agreement on harmonisation, let alone for transnational companies to operate.

Technological Development and Dual Use

Technological developments provide the strongest force counterbalancing national problems, preferences and differences. The key development is the change toward 'dual use' products, i.e. products that are designed for military use but have significant civilian applications (spin-off), or vice versa (spin-in). The increasing prevalence of dual use products means that the traditional distinction between military and civilian specifications is becoming increasingly blurred, with the prospect that military specifications may be replaced with commercial standards. This in turn allows the European Commission some leeway in terms of beginning to comment on defence procurement, despite the defence exemption. Moreover, it is increasingly the case that states cannot go it alone in terms of defence procurement, and in the context of pressure for cost effectiveness this has generated a degree of pressure for re-evaluation and harmonisation of military requirements

The Single European Market

Although the defence sector is exempt from EU rules, the competencies of the EU are gradually being extended toward, if not into, the sector. The European Commission represents the key driving force here, and has focussed on R&D, standardisation and public procurement rules. However, the links between military-industrial policy and the ESDP remain so limited that it is hardly appropriate to speak of an integrated approach to defence procurement. Defence procurement therefore pertains partly to the single market, the EU's first pillar where the Commission has considerable competencies, and partly to the foreign and security policy pillar where policy is made largely by the states. In the latter domain the ad hoc European Armaments Policy Groups (POLARM) hardly counts as a success, as it features non-binding agreements and deliberations have been slow. Nevertheless, given the increasing relevance of single market rules, especially in the context of dual use products, the Commission is likely to take on an increasingly significant regulatory role even in the defence sector.

The Changing Defence Industry in Europe

Finally, the defence industry is providing a significant degree of pressure for change. Despite national differences, there has been a recent growth of mergers and acquisitions, yielding a European defence industry that is increasingly characterised by transnational defence corporations. Fears that mergers might be hampered by government rules on technical information provided part of the logic behind the LoI initiative. Recent mergers and acquisitions have seen the emergence of two strong transnational defence companies: BAE Systems resulting from British Aerospace's acquisition of Marconi Electronic Systems; and the European Aeronautic Defence and Space Company (EADS) that was established with the merger of Aerospatiale-Matra, DASA and CASA of respectively France, Germany and Spain.

Toward a European Armament Agency?

The central if somewhat nebulous and ambitious goal in terms of developing a common policy on arms procurement in Europe remains a European Armaments Agency (EAA). A group was set up to work on this in 1993, following a WEU declaration to the effect that further examination of “proposals for enhanced co-operation in the field of armaments with the aim of creating a European armaments agency” was required. Consequently, WEU ministers established the Western European Armaments Organisation (WEAO) in 1996, but work on an EAA remains in slow progress. The Assembly of the WEU, which brings together national parliamentarians for its member states, has repeatedly come out in favour of establishing a European Armaments Agency, most recently in June 2002.

One option is to do this by converting WEAG into an EAA. However, although the National Armaments Directors (NADs) have been working on a Masterplan for the EAA, developed in 1998, this has been put on ice until conditions are more favourable. Whether this would be included in the EU is uncertain, a development in the shape of a parallel initiative that may one day be integrated (the Schengen model) is perhaps more likely.

European Union Initiatives

The European Commission's Strategy

At the EU level, the Commission has naturally taken advantage of developments such as the defence industry mergers to advance into the realm of defence procurement and security policy, even if this has largely been confined to its R&D competence so far. Despite the special status of the defence industry, the Commission increasingly regards aspects of this as falling under the scope of the Single Market. In 1996 and 1997 it published two *communications* on the defence industry, emphasising the strategic importance of common standards and harmonisation in the context of the completion of the Single European Market, and calling for restructuring of the European defence industry. This in effect constitutes a proposal for a single market in armaments. Through

its competition policy role (or as a regulator) the Commission would then gain a considerable supervisory role in the sector. Unsurprisingly, many states resist this. The Commission followed this up by embarking on a number of studies of various aspects of the defence industry, and called for a common armaments policy, but with little or no tangible effect. Moreover, the Commission is attempting to ensure that the defence exemption is limited to strictly military matters. E.g. it recently challenged the German contracts for rubber protection pads for military vehicles that were awarded without an EU invitation to tender, on the grounds that these are used in peacetime for non-military activities.

The Council of Ministers

European armaments policy is also under discussion at the Council of Ministers, where progress is slow because of national differences. In the spring of 2002 the Spanish Presidency presented a set of principles and guidelines for armaments policy which by no means go as far as the Commission's proposals. These principles and guidelines

- put defence procurement in the service of European common defence policy
- call for the establishment of an EAA as an umbrella organisation that encompasses OCCAR
- are based on voluntary participation, transparency and co-operation with other organisations such as NATO
- develop medium to long term techniques for new programmes and co-ordination of calls for tenders
- harmonise operational requirements
- define compatibility criteria for finance of armaments
- co-ordinate R&D efforts
- promote pooling of arms between member states
- foster mergers between defence companies
- and specify the role of National Armaments Directors.

Assessment

Over the last five years the Commission has adopted a somewhat higher profile on defence procurement, in pursuit of common arms procurement rules and a single armaments market. However, this requires not only member state support, but also a degree of integration with ESDP. There is no member state consensus in favour of this. Although several governments regard offset as a necessary evil and would prefer a single armaments market under common procurement rules, there is enough opposition to prevent it. Moreover, the big four have opted for more pragmatic and incremental solutions, preferring the OCCAR and LoI approach to extending the Commission's competencies in this field. To the extent that common arrangements develop and operationalised, these are set to work primarily on an inter-governmental basis, linked only partially to the EU. The three central institutions are addressed below.

WEAG

The West European Armaments Group grew out of the Independent European Programme Group (IEPG), a 1976 European NATO nations (except Iceland) initiative to establish a forum for armaments co-operation. It was transformed to the WEAG in 1992, and is currently made up of 19 member states. The three most recent EU members Austria, Sweden, Finland joined in November 2000, as did the three new NATO members the Czech Republic, Hungary and Poland. Others include the EU members Denmark, Germany, France, Italy, Belgium, the Netherlands, Luxembourg, Spain, Portugal, Greece and the UK, as well as NATO members Norway and Turkey. It is sometimes described as the (future) industrial dimension of ESDP.

The objectives are:

- more efficient use of resources through increased harmonization of requirements
- the opening up of national defence markets to cross-border competition
- strengthening the European defence technological and industrial base

- co-operation in research and development.

WEAGs basic principles are that all member states should participate fully in European arms procurement co-operation, that there should be a single forum for this purpose, and that arms procurement should be managed by the National Armaments Directors (accountable to national ministries of defence). Links with NATO are therefore maintained.

The West European Armaments Organisation (WEAO) was established within the WEAG framework (but with its own legal personality) in 1996. Although it was designed as a possible future armaments agency, it has been limited to research and technology projects so far, and even these have been limited. Moreover, as a possible arms procurement body it has been superseded by OCCAR.

Experiences and Current Status

Progress within the WEAG has been relatively slow, leading only to limited agreements, although it has improved discussion among its member states. These limits partly reflect the fact that its agreements are not legally binding. R&D is among the more successful elements of operation to date, partly because WEAO provided a clear legal framework for research and technology decisions giving it the ability to enter contracts. In May 2001, a memorandum on co-operation in research in the armaments sector was signed by WEAG defence ministers to enable groups of governments and industry to form small research teams for the development of secret projects.

Assessment

Although WEAG can hardly be said to have met the goal of generating co-ordinated arms procurement, it has improved inter-state co-operation and some harmonisation of procedures. It remains primarily a forum for discussing armaments matters, and the only

forum that includes most EU and European NATO states. Its main potential is therefore as a forum for drawing up broad frameworks for harmonisation of defence procurement. Although the principal arms producers in Europe, Germany, France, Italy and the UK have opted for closer co-operation in smaller groups, WEAG's potential strength lies in the fact that it remains the only comprehensive initiative and that it works.

OCCAR

The Organisation for Joint Armaments Co-operation, based in Bonn, has become a joint European procurement agency. Founded in 1996 by Germany, France, Italy and the UK, and designed to improve the management of collaborative armament programmes, it gained legal status in January 2001. This enables it to sign contracts with industry on behalf of its member states, but non-members are invited to participate in its programmes on a case-by-case basis. The four original signatories cover well over two-thirds of European defence production. The Netherlands, Spain and Belgium have since expressed interest in membership, despite some misgivings, and several states are participating in OCCAR projects.

The governments that set it up agreed to allot shares of work based on total set of projects it manages rather than on a programme-by-programme basis. This replaces the *juste retour* principle, which sought to align work-share and cost-share between countries in each collective programme.

Its five basic principles include:

- replacing *juste retour* with 'global balance'
- securing the profitability of the armaments industry
- harmonisation of requirements and technology
- promoting a competitive industrial base
- opening the door to other countries

Experiences and Current Status

OCCAR inherited a number of projects including the GTK/MRAV armoured vehicle, Tiger helicopters, Roland air defence systems and Milan and Hot anti-tank missiles, as well as a series of bi- and tri-lateral projects. The Corba anti-artillery radar was its first integrated project, and the Airbus A400M deal, which OCCAR is set to sign off, is its first new programme. It will manage the programme as the contracting authority delegated by the states. Although the A400M project was agreed by eight European governments in December 2001, with Italy pulling out at the last moment, it has encountered further problems and delays in terms of uncertainty surrounding Germany's and Portugal's orders. The project thus illustrates some of the problems inherent in co-operation on defence procurement. However, it also illustrates that non-OCCAR members may participate in programmes on an ad hoc basis, thereby reinforcing the idea of OCCAR as the key basis for future and wider co-operation. With the accumulation of programmes OCCAR's importance has grown, and its case-by-case operation offers some potential for establishing 'best practice'. In the light of these experiences, OCCAR has generally been welcomed by industry as a potential basis for multi-lateral defence procurement programmes.

Assessment

Because OCCAR inherited most of its projects, including their flaws, it has yet to be fully tested. The A400M project is providing the first such test, and it indicates that many of the problems involved in co-ordinated defence procurement between national governments remain. It has met more scepticism from the smaller states than from the big states, which see this as a means for replacing offset with something more efficient but of more or less equal effect. Smaller states are simply less able to extract benefits from these programmes. Nevertheless, the Netherlands and Belgium are expected to join, and despite some misgivings other states are interested. In effect, OCCAR replaces offset with a more

co-operative compensation regime, but questions remain as to whether this is actually more efficient than offset in terms of costs.

The Letter of Intent/Framework Agreement

In July 2000, the UK, France, Germany, Italy, Spain and Sweden signed the Framework Agreement based on the Letter of Intent of 1998, an accord designed to ease export restrictions and thereby encourage cross-border mergers and joint ventures in the defence industry and harmonise national rules related to defence procurement. Signed after more than two years of negotiations, the protracted process indicated the difficulties involved in co-ordinating defence procurement.

The LoI/FA addresses and regulates seven areas

- export procedures
- security of supply
- security of information
- protection of sensitive information
- treatment of technical information
- research and technology
- harmonisation of operational requirements

The signatories are therefore committed to simplifying export procedures; not to hinder the supply of defence material to other states; to simplify security procedures and harmonise contracting procedures regarding technical information and to harmonise military requirements and equipment planning. Under the topic research and technology joint research programmes are to be fostered.

Experiences and Current Status

Although the LoI/FA has not operated long, it has seen some success on procedures for research and technology and the states have agreed to harmonise procurement policy and joint requirements as well as procurement methods. The main achievement is the establishment of a forum where technical issues and industrial policy is discussed, with a view to solving specific problems and addressing the main obstacles to armaments co-operation.

Assessment

Like OCCAR, the LoI/FA represents a pragmatic attempt to address the pressures for changes in defence procurement policies without incorporating this into the EU single market. Again this is largely a big state initiative, albeit with Swedish participation. However, whereas OCCAR operates on a case-by-case or programme-by-programme basis, LoI/FA provides a forum for technical and political harmonisation. Because the initiative is geared toward harmonisation it is perceived as a potential precursor to or building bloc on the way to a single market in armaments. It is too recent to judge as a major success or failure, but medium term success will be measured in terms of whether it establishes a framework within which transnational defence companies can operate effectively.

Conclusion

After more than two decades' efforts to establish a degree of co-operation in European defence procurement under WEU auspices, the OCCAR and LoI/FA initiatives have accelerated progress toward a common armament policy, or at least a gradual replacement of bi-lateral offset. However, the prospect of a common arms procurement policy and a European Armaments Agency remain some way off. Although OCCAR and LoI/FA offer the prospect of a degree of replacement of offset, at least by the big four defence producing states, questions remain as to how well this will work. Given the range of products in the big states' defence industries, the question may not be terribly salient,

because they can achieve much the same level of protection through joint programmes as case-by-case offset.

Offset arrangements are to some extent a type of prisoners' dilemma, where individual rational pursuit of self interest prevents co-operation that would benefit the actors involved. To the extent that this is the case, much of the problem could be solved by establishing a single armaments policy, and possibly expanding the role of the European Commission. However, the close identification of interests between national defence industries and governments means that this is more than a co-ordination problem. Most states have tended to regard offset as necessary to compensate for defence expenditure abroad, and it has long been considered apparent that their industry benefits from such protection. However, with a shift toward increasing focus on the benefits of free trade, states that believe their companies to be competitive on the international markets, such as Sweden and the Netherlands, increasingly regard offset as a necessary evil rather than an unequivocal benefit.

The question is therefore whether, how and to what extent existing initiatives may form the basis for Europeanisation of defence procurement. In the short to medium terms, the prospects are limited, because of resistance from states as well as problems of co-ordination. Although most if not all governments express some exacerbation with the current system, even the big states provide obstacles. France protects its industry from competition, Spain proactively uses offset and other compensatory arrangements as essential components of its expansive industrial policy in the sector, and even the UK has drawn accusations of acting in a protectionist manner (under both Conservative and Labour governments). WEAG, OCCAR and LoI are therefore very much second best solutions to the offset problem. Strictly speaking, these measures conflict somewhat with the Single European Market's principles of open free trade. However, they are set to remain central for defence procurement co-operation for some time. WEAG continues to provide the main forum for discussions, LoI the main arena for technical and political harmonisation, and OCCAR the key vehicle for procurement and co-operation on specific

programmes. Yet all these initiatives remain very much as the stage of initial establishment, and a common armaments policy remains a long way off.