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

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

IMPACT ASSESSMENT

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EXECUTIVE SUMMARY

This impact assessment refers to a Communication entitled “A Strategy for a stronger and more competitive European Defence Industry”. The Commission has already reported on developments and challenges for the European defence industry several times and adopted Communications on the defence industry in 1997 and 2003.

The purpose of this Communication is to highlight current obstacles for this sector and to indicate directions for possible future actions. It presents the issues of relevance for the competitiveness of the defence industry and proposes the areas in which further study or action is required. The Communication is an overall policy document which will be presented together with two Commission legislative proposals, on procurement and intra-EU transfers of defence goods. These specific proposals have been developed over the last few years on the basis of the 2003 Communication and other initiatives. They will be the subject of their own separate impact assessments.

The objective of the Communication is not to propose alternative ways to solve a well-described problem, but rather to identify and highlight certain areas where future action could contribute to the competitiveness of the European defence industry. This is reflected in the present document which follows the impact assessment guidelines as closely as possible while remaining proportionate to the nature of the Communication itself.

Given the central role of governments in this sector, resulting from the importance of the industry for national security considerations, major initiatives to increase or maintain the competitiveness of the sector, will only achieve their greatest impact if Member States also take complementary action within their own broad areas of responsibility. However this does not detract from the Commission’s responsibility regarding the industrial competitiveness of the EU as reflected in this strategic Communication, which voices coherent views on the future of the defence industry and invites the Community, Member States and the European Defence Agency to take action.

The impact assessment is structured as follows: Section 1 gives an introduction to the political and legal background of the European defence sector. Section 2 describes the stakeholder consultations undertaken in the last 18 months to identify problems and pressing issues. Current problems and obstacles for the sector will be identified (Section 3) and the objectives are described in section 4. Possible policy options are developed in Section 5 and assessed regarding their economic, social and environmental impacts (Section 6). The options are compared in section 7 and indications on monitoring are given in Section 8.

Should any of the policy options discussed in this impact assessment lead to legislation in the future, the latter would be accompanied by a separate impact assessment in the same manner as the two proposals submitted together with the Communication.

1. POLITICAL AND LEGAL CONTEXT

1.1. Policy Background

Since 1996¹, the Commission has reported several times on developments and challenges for the European defence industry. It has identified trends including declining output, reduced employment and decreased sales in response to declining or stagnating national defence budgets.

In 1997² the Commission adopted a Communication on “Implementing European Union Strategy on defence-related Industries”. Two key steps to support the industry were identified. The first involved the setting up of a policy to deal with intra-Community transfers, public procurement of defence goods and common customs arrangements between Member States. The second was the drawing-up of an Action Plan including a list of areas in which EU action was necessary.

In 2003, the Commission published further proposals for an EU defence equipment policy³. These set out the objectives and actions necessary in fields such as standardisation, mapping the defence industrial economic and industrial landscape, intra-EU transfers of defence goods, competition in the defence sector, research, and procurement to create a more sustainable industry. It proposed to look more closely at certain issues and called for the creation of an Agency to oversee and pursue work on a European defence equipment market.

On the basis of the 2003 Communication, many initiatives were taken by the Commission and by EU Member States. In 2004 the Council of Ministers established the European Defence Agency to improve European defence capabilities in the field of crisis management and to sustain the European Security and Defence Policy (ESDP). Also in 2004, the Commission published a Green Paper on defence procurement⁴, followed in 2005 by a Communication on the results of the consultation launched by the Green Paper on Defence Procurement⁵ and in 2006 by an Interpretative Communication on the application of Article 296 of the Treaty in the field of defence procurement⁶. Furthermore, the Commission continued its work on a European Handbook for Defence Procurement⁷ which is ready for use online. A mapping exercise to monitor defence related industries to get a clearer picture of the defence industrial and economic landscape in Europe was launched and the first results are expected in 2008. A consultation with Member States on the need for a security-related research agenda was carried out and resulted in a security research programme which is part of the 7th Framework programme.

There are many other areas where some developments are expected in the future, for example with regard to defence research, pooling of demand and defence trade issues. It has however to be noted that the framework for the defence industry is mainly the responsibility of

¹ The Challenges Facing the European Defence-Related Industry, A Contribution for Action at European Level, COM(1996)10 Final dated 24 January 1996.

² Implementing European Union Strategy on Defence-Related Industries - COM(97) 583, 4.12.1997.

³ Towards an EU Defence Equipment Policy, COM(2003)113 Final dated 11 March 2003.

⁴ COM(2004) 608, 23.9.2004.

⁵ COM(2005) 626, 6.12.2005.

⁶ COM(2006) 779, 7.12.2006.

⁷ Available at www.defence-handbook.org.

Member States, but the Commission will highlight these and other new areas for possible action by the Commission, Member States or European Defence Agency (EDA) in this Impact Assessment, which accompanies a new Commission Communication to outline challenges ahead and propose directions for future action. Underpinning the policy Communication will be two other legislative proposals: A Directive on defence procurement and a Directive on intra-EU transfers of defence goods. Both proposals will be accompanied by their own, separate impact assessments.

1.2. *Legal Context*

The Common Foreign and Security Policy (CFSP) is developed under a separate pillar of the European Union. Because of its intergovernmental nature, the Commission cannot take decisions in this matter, but it conducts many policies, which have an impact on the CFSP. In the context of the CFSP, the EU is developing a common security policy⁸, covering all questions relating to its security, “including the progressive framing of a common defence policy, which might lead to a common defence, should the European Council so decide”⁹.

In 2004, the Council established the EDA in which 26 EU Member States participate¹⁰. The Council underlined the need to coordinate defence-related activities better and tasked EDA in a Joint Action¹¹ to

- develop defence capabilities;
- promote defence research and technology (R&T);
- promote armaments co-operation;
- create a competitive European Defence Equipment Market and strengthening the European Defence, Technological and Industrial Base.

The Commission is a non-voting member of the EDA Ministerial Steering Board.

In its GAERC meeting in November 2006, the Council underlined the importance of this cooperation: “*The Council noted with satisfaction efforts to ensure good coordination and complementarity between the EDA and the Commission*”¹². This coordination is necessary to reap the benefits of civil-military synergies, for example in the area of research, and to increase the efficiency of EDA and Commission initiatives targeting similar issues (e.g. procurement of defence goods, mapping of the defence industry or standardisation).

Hence, the Commission is explicitly called on by the Council to work together in all areas with the EDA and to ensure synergies and good coordination.

⁸ Article 11 Treaty of the European Union.

⁹ Article 17 Treaty of the European Union.

¹⁰ The 27 EU Member States except Denmark.

¹¹ Council Joint Action 2204/551 of 12 June 2004 on the establishment of the European Defence Agency.

¹² Conclusions of the General Affairs and External Relations Council, 2761st meeting on 13 November 2006.

With regard to the competencies of the Commission in the area of industrial policy, Article 157 EC requires the Community and the Member States to ensure the existence of the conditions necessary for the competitiveness of industry, including the defence industry.

However, Member States may in specific cases invoke Article 296 EC. This article authorises Member States to refuse the disclosure of information to the Community, where they consider that to be essential for their national security. Furthermore, a Member State may take all measures it considers necessary for the protection of the essential interests of its security which are connected with the production or trade in arms, munitions and war material. Procurement for non-military security purposes, by contrast, is excluded from the field of application of Article 296(1)(b) EC. For these procurements, security interests may justify the exemption from Community rules on the basis of Article 14 of the Public Procurement Directive, provided that the conditions for its application are met.

1.3. Links with the Lisbon strategy

The Lisbon strategy for growth and jobs emphasises the following issues, to which an industrial policy for the European defence industry will contribute:

- Building up the internal market and improving European and national regulations

The proposals on intra-Community transfers and on defence procurement will propose common rules for the, still fragmented, European defence equipment market which would lead to a more uniform application of national legislation, more EU-wide procurement of defence goods and hence to a more European supply chain.

- Encourage knowledge and innovation by promoting more investment in research and development

An industrial policy for the defence industry will highlight the need for more research and development in line with the Lisbon goal to increase research investment with the aim of approaching 3% of GDP. Whereas the United States spends 3.3% of total defence expenditure on defence research and technology, the EU Member States together spend only 1.1%.

EU Member States could increase the efficiency of research spending if they pool research activities and work more closely together for example through the EDA. The Communication will explicitly highlight this issue.

Furthermore, it could be considered to promote the use of synergies between civil and military research. It is probable that the European Security Research Programme will co-finance technology developments which might lead to dual-use applications. Exploring synergies in civil and military research would mutually increase the knowledge and innovation about civil and military technologies.

- More and better jobs

The development of new defence technologies, especially the increasing complexity of defence systems, will require excellent technological skills and a well trained workforce. An

industrial policy for the defence sector will emphasize the need for Member States and industry to better coordinate the national programmes, work more together and ensure that all capabilities are available which are needed for a European Security and Defence Policy. This cooperation would ensure the best use of available resources and the identification of new technologies and products needed for future defence missions. A European defence industry able to respond to all future military needs will require continuous investment in the development of skills and will also provide new opportunities for other sectors to contribute to the development of future defence related technologies.

2. STAKEHOLDER CONSULTATIONS

Given the specificity of the sector and the limited impacts on the general public regarding industrial policy measures targeting the defence industry, a targeted stakeholder consultation was undertaken as part of a study commissioned from a consultant in 2006. A consultation questionnaire was prepared by the Commission and over 140 organisations were invited to respond (the Ministries of Defence of EU 27 and the Candidate Countries, 20 national industry associations, 3 third countries (United States, Russia, Israel), the European Defence Agency, 15 national trade unions dealing with the defence sector, large defence companies, small and medium-sized defence companies and research institutes specialised on defence economics).

The questionnaire was provided on a special website in English, French and German. The stakeholders selected for consultation were contacted by e-mail and invited to fill in the questionnaire on-line. The responders could be kept anonymous, but stakeholder could provide more information about their organisation if they wished to do so. Some provided the Commission and the consultant with position papers or detailed remarks. The consultation was launched on 10.07.2006. Two reminders were sent by e-mail to the stakeholders (one after 4 weeks and one after 6 weeks). The consultation was closed on 8 September 2006.

An inter-service steering group¹³ was set up to accompany the work undertaken by the consultant, to provide further input and to validate the results. It met three times in the course of the study.

40 responses were received from 18 identifiable countries across the EU. The respondents comprised:

- 12 responses from Member States;
- 14 responses from large enterprises and industry associations;
- 6 responses from Small and Medium Enterprises (SMEs); and
- 8 responses from ‘other’ organisations (trade unions, research organisations and responses of unknown origin).

¹³ Services involved were the Secretariat General, the Legal Service, DG MARKT, DG RELEX, DG RTD, DG COMP, DG EMPL, DG INFSO, DG FISH, DG TRADE and the JRC.

No identifiable responses from third countries were received.

As can be seen from the summary above, not all EU Member States reacted to this consultation. However, the issues analysed in this impact assessment were also discussed by Member States' representatives in the Ministerial Steering Board Meetings of the EDA, which took place on 13 November 2006 and 14 May 2007.

Five meetings were organised jointly by the European Commission and the European Defence Agency with representatives of the European defence industry took place in 2006 and 2007 to discuss major issues for industry:

- 14 October 2005 (in Commission premises)
- 27 January 2006 (in EDA premises)
- 24 April 2006 (high-level industrialist roundtable chaired by the Vice-President for Enterprise and Industry) (in Commission premises)
- 8 December 2006 (in Commission premises)
- 1 June 2007 (in EDA premises).

Two conferences open to all interested stakeholders, one on 9 February 2006 on research and technology and one on 1 February 2007 on the European Defence Technological and Industrial (EDTIB) were organised by EDA. The Finnish Council Presidency also organised a conference for Member States to discuss options to improve the EDTIB on 17 November 2006. Furthermore, DG ENTR met with representatives of the European Metal Workers Federation on 29 May 2007 to identify problems for the sector and discuss possible ways forward. An inter-service meeting to discuss the impact assessment took place on 31 May 2007.

The qualitative responses received to the questionnaire and the many discussions with stakeholders were important to verify the needs and obstacles currently observed in the defence sector. The results of these consultations are reflected in the Communication and the minimum standards for consultation have been applied.

The vast majority of the stakeholders consulted were of the opinion that the existing framework conditions in which they operate were not adequate to assure the long-term competitiveness of the European defence industry. The obstacles to competitiveness perceived by many stakeholders included, for example, the lack of common rules for a European defence equipment market, the unbalanced defence trade relationship between the EU and the US and the lack of coordination of national strategies for defence research and technology.

3. PROBLEM DEFINITION

The EU defence industry operates in a complex political and economic environment. The industrial defence capabilities existing today reflect the national policy priorities of the Member States. Enterprises operate in national markets, the supply chains are national and the

most important customer is the nation state. From a European perspective, this leads to inefficiencies and duplication of programmes.

Currently for example, there are 23 parallel development programmes for armoured fighting vehicles in Europe. While the US has 27 different major weapon programmes, EU Member States currently have a total of 89¹⁴. Another example which illustrates the lack of cooperation in Europe is that only about 14% of defence R&T is spent in collaborative projects, whereas 86% is spent nationally (see Annex 1). Thus there is scope for more co-operation and common programmes.

It should also be noted that the combined defence budgets of EU Member States have only slightly increased in the last decade, despite the growing complexity of requirements for future programmes. EU defence companies need to consolidate further in order to preserve economies of scale and manage the level of investment needed to stay competitive vis-à-vis US counterparts on international markets, where EU and US products directly compete.

The problems identified can be grouped into three broad areas:

(1) Framework conditions for industry

- The development of new, ever more sophisticated defence related technologies becoming increasingly expensive and leading to a situation where **national defence budgets can no longer finance top quality products**. New defence programmes are not sufficiently co-ordinated at the European level, which leads to **duplication** and impedes synergies and economies of scale for the companies involved in **different programmes**.
- Defence **research and development** is also mainly undertaken **at a national level**, which leads to duplication of programmes and less efficiency than a more coordinated approach

(2) Defence market issues

- Member States tend to procure defence goods from national suppliers. This leads to **market fragmentation**, national supply chains and obstacles for co-operation at the European level.
- National foreign policy priorities can lead to a situation in which transfers of defence products to other EU Member States are stopped. This leads to a **lack of security of supply** of defence equipment for the customer.
- The absence of a Community regime for **security of sensitive industrial information** can lead to discrimination against suppliers from other EU Member States.
- SMEs are mainly involved in national supply chains. If cross-border procurement at European level develops further – as can be expected with the adoption of the Code of Conduct on Defence Procurement adopted by the EDA in 2006 – care has to be taken that **SMEs** must also benefit from the opportunities at European level.

¹⁴ Richard Bitzinger, “European Defence’s never ending death spiral”, RSIS Commentaries, 4 April 2007 and Hartmut Kuechle, “The cost of non-Europe in the area of security and defence“, European Parliament, 2006.

- Current **offset requirements**, which are often part of a procurement contract, could lead to distortions in the internal market.
- Given the mainly nationally organised supply chains, **standardisation of defence equipment** at European level is not sufficiently developed. A European Defence Equipment Market needs a common system of standards to simplify cross-border procurement.
- The creation of a European defence equipment market could lead to **market distortions** if **EU competition legislation** is not effectively applied for this sector.

(3) Other areas

- The defence **trade relationship with the United States** is very **unbalanced**. Most EU defence companies have only marginal access to the US market, whereas US companies have almost full access to the EU market.
- Market reform inevitably results in change and the **need to adjust**. Whilst this can bring overall benefits to the economy and citizens, some workers and regions may lose out in the shorter run.

All these problems mentioned above have an EU dimension and call for action at the EU level. Member States alone will not be able to achieve progress in most of these matters on their own. Therefore the involvement of the Commission and the EDA create substantial added-value.

4. OBJECTIVE

A competitive European Defence Technological and Industrial (EDTIB) base is necessary to support the European Security and Defence Policy. Failure to safeguard a competitive defence industrial base, and loss of autonomous design and innovation capabilities, limits available choice and increases the dependency on non-European suppliers of defence goods. A competitive EDTIB requires an efficient European Defence Equipment Market (EDEM). A well-functioning European market requires an improvement to currently fragmented legal and regulatory framework, which is based on national legislation and imposes many burdens on companies.

Given the wide range of different problems identified in the Problem Definition, it seems useful to develop specific objectives and develop policy options, which address the need to promote and maintain an appropriate EDTIB and a well functioning EDEM:

(4) Framework conditions for industry

- Member States should increasingly **pool demand on defence markets** in order to overcome market fragmentation and to remove obstacles for cross-border industrial cooperation. This objective can only be achieved if Member States take action, possibly supported by the European Defence Agency.
- Member States should increasingly **pool demand for military research and development** of new defence related technologies. Duplication of research programmes due to the reason

that military research is primarily undertaken at national level leads from a European perspective to inefficiency of spending. This objective can mainly be achieved by Member States' action, but the Commission can contribute to the objective by coordinating the security research programme of the Community with research initiatives supported by the EDA.

(5) Defence market issues

- Provisions to take into account the need for **security of supply and security of information** would be of utmost importance to build trust among Member States and ensure the proper functioning of a European Defence Equipment Market. However, as these issues touch on national security interests of Member States, any proposal in this area would in a first step focus on further analysis on possibilities for an EU regime.
- The involvement of innovative **SMEs** in the supply chain of the European defence industry should be fostered. The EDA is addressing SME issues with its Code of Best Practice in the supply chain. As SMEs are an important element of the industrial policy of the EU, it is important that the Commission monitors the involvement of SMEs in the defence supply chain and proposes measures if obstacles for SME participation are observed.
- Offsets are widely used in the EU and abroad and are often required under national legislation. However, **offsets** as part of defence procurement contracts can distort competition in the internal market. The ultimate aim should be to create the market conditions and the European DTIB structure in which the practice may be no longer needed. To that purpose the Commission and the EDA could study the impacts of offsets further.
- Make use of **standards** for defence equipment to ensure cost efficiency and interoperability of defence equipment. A European Handbook for Defence Procurement is available for the Member States, but the use of these standards for defence procurement is not binding. The Commission and the EDA could further encourage the use of the standards published in the Handbook.
- Ensure **fair competition** on the European market. The stepwise creation of a truly European Defence Equipment Market will need to ensure that measures which could put some companies in a more advantageous position than others (for example through state aid) are appropriately controlled. The Commission would need to ensure that a level playing field is established and that Member States assume their obligation to notify aid measures of mergers in the defence sector, even if the measure would, after examination, be considered to fall under Article 296 EC.

(6) Other areas

- Work towards **more balanced transatlantic relationships**. The defence trade imbalance between the EU and the USA would need to be analysed and addressed by the Commission in an appropriate forum.
- Identify and address **access barriers to third markets**. Defence trade barriers with third countries could be included by the Commission in the Market Access Database to gather an inventory of possible obstacles.

- **Anticipate change** and adjustment costs and accompany them, as necessary, with appropriate measures.. The Commission would consult stakeholders and study economic adjustment processes in the defence industry to be able to develop measures and/or strategies to timely address possible adjustment problems.

5. DEVELOPMENT OF POLICY OPTIONS

Having examined the problems and challenges facing the defence industry and its specific situation with regard to the exercise of national sovereignty, there are basically 3 options open to the Commission:

- Option 1: Do nothing or “business as usual”

This option would imply that no initiatives at EU level were launched by the Commission with the aim of strengthening the EDTIB or creating an EDEM, in line with the specific objectives listed in section 5. However, this does not necessarily mean that no action would be taken at all, because some Member States might in certain cases decide to act among themselves, including within EDA, or on the basis of bilateral agreements or voluntary arrangements.

- Option 2: Immediate action in all areas where the defence industry is currently treated differently to other industrial sectors

Such an approach would imply that immediate steps be taken in order to integrate defence goods fully into the single market by, for example, removing all obstacles to free movement inside the EU, immediately prohibiting offsets, regulating trade with third countries at EU level and attacking restrictions on freedom of investment in defence companies without any prior consensus among stakeholders affected by such an initiative. Even more ambitious steps such as opening European demand for defence goods and financing European defence R&D, would imply making available the corresponding budget at EU level.

- Option 3: A step by step approach, intensifying the process with immediate steps where appropriate and working with other stakeholders to identify and prepare further areas of work

This approach would focus on initiatives that could probably be agreed with Member States in the short-term and would identify areas where action should be taken in the medium-term or where further study was needed for the long-term. It would however not address all identified problems immediately but rather aim at intensifying the dialogue with stakeholders and cooperating with other key actors.

6. ASSESSMENT OF POLICY OPTIONS

6.1. *Option 1: Do nothing or “business as usual”*

Economic impact

Under this option, most aspects of a defence industrial policy would still remain under almost exclusive national control. As a consequence, there would be no systematic co-ordination of defence-industrial policies at a European level.

The economic environment under which firms operate would first remain stable as dislocation costs would not be felt immediately. Certain actors presently enjoying relatively hermetic national markets would continue to avoid the pressure of international competition. However, as defence budgets may very likely experience continued downward pressure, Member States will be less and less able to influence/guide industrial consolidation through co-operative programmes and to maintain the financial and technological competitiveness of the EDTIB.

Moreover, the technical complexity of systems, and “systems of systems”, will likely to increase and, with it, the cost of modern equipment. The introduction of modern development tools and production technologies, as well as a stronger reliance on military/commercial off-the-shelf products combined with new procurement policies, may reduce the degree of increase but very likely will not dramatically alter this development. Thus the abovementioned budget trends have to be seen against the background of increasing equipment costs – a combination further reducing new business opportunities.

It is likely that European governments will not spend substantially more on defence and especially not on R&T and the development and production of equipment. If in the absence of sustained budget increases a European defence equipment market and a common European defence industrial policy would not materialise, national sub-optimisation will prevail.

In this case, the efficiency of defence spending could (at best) only slightly be increased as national industrial policies would prevail. Pre-financing, outsourcing, and the use of alternative financial instruments would dominate and lead to concentration processes within the national industry and to ever closer partnerships between governments and national primes and key suppliers, further reducing chances for cross-border competition within the supply chain.

New programmes would be few and industry would adapt to stagnant R&T expenditures. Such a development would not provide a sufficient business case for many of the current industrial players. As the industry is more and more driven by shareholders' interests, companies would, in this perspective, look for more attractive markets and/or opportunities to reduce their cost structure. This could lead to a substantial relocation of production and, strategically more importantly, even R&T facilities outside Europe, leading eventually to a reduction in the role of European industry in general to that of niche players and suppliers to mostly non-European primes.

While certain actions could be taken without a Commission initiative for example by groups of Member States or the EDA, experience demonstrates that the involvement of all stakeholders of the defence sector is necessary in order to make progress. Moreover, on the conduct of the policies for which it is responsible, the Commission has a role to play, and a duty to act vis-à-vis this important sector, both from an economic and a strategic point of view. This is the case of course for the internal market (defence procurement rules and intra-Community transfers of defence goods), but also for industrial policy (competitiveness, innovation, encouragement of SMEs, standardisation), the application of competition law, research (ensuring synergies between security research and defence research) or trade policies (for example balanced trade relations with third countries).

In these areas, other potential actors would either be unwilling or, if willing, unable to act and would envisage only voluntary, non-binding intergovernmental instruments very often lacking the full EU perspective.

Social impact

No action at EU level to increasingly pool demand on defence equipment and more cooperation in research and development would probably delay necessary restructuring efforts due to stagnating defence budgets. This could lead to adaptation processes which could, in the end, be more disruptive if it were too slow to ensure the competitiveness of the European defence industry and employment in this sector. It is expected that defence-related employment levels in the different Member States will mainly depend on the defence expenditure of the national governments. Declining defence budgets or more imports from third countries will therefore probably lead to a reduction of employment, whereas an increase in defence expenditure would probably lead to more national employment. These developments are very much depending on Member States' action and difficult to predict. However, the current trend to more privatisation of industry, flat defence budgets could lead to a situation in which future innovative technologies are increasingly developed abroad and, especially high-skilled jobs would follow this development.

No Commission initiatives to help innovative SMEs to better integrate into a European supply chain to face the challenges of an increasingly European market might lead to a lower participation rate of SMEs in a future EDEM and thus reduced opportunities for new, innovative approaches and employment opportunities.

If there were no EU action aiming at balancing trade with third countries, especially the United States, there would probably be no tangible progress in the medium term, which might reinforce a trend for European companies to relocate work to the US to be able to sell to US customers. This could lead to an increasing shift of employment in this sector from EU territory to the US.

Environmental impact

No material impacts on the environment are expected.

6.2. *Option 2: Immediate action in all areas where the defence industry is currently treated differently to other industrial sectors*

Economic impact

It could be argued that, given its importance and time already elapsed since the first analysis of the European situation was formulated, it is urgent for the Commission to act forcefully and immediately on objectives along the same lines as any other industrial sector without taking into account the peculiarities of the defence industry.

Such an approach would be coherent, relatively easy to describe and require minimal delays for its definition. It would aim at fully exploiting the potential of the EDEM to allow the defence technological and industrial base in the EU to become integrated and truly European.

This approach would therefore aim at a maximum of coordination and harmonisation of approaches and national legislation at the European level. The Commission could take

immediate action for example with regard to support to SMEs, a more efficient application of competition law to the defence sector or propose rules for security of information.

However, in many cases, the Commission does not have all the necessary instruments at its disposal. There is, for instance, no budget at the EU level that would allow a pooling of demand for defence products and the existing research budget available to the EDA is minimal.

An immediate phasing-out of offsets could also present legal difficulties and economic uncertainties as regards the consequences for European industrial competitiveness in relation to third countries.

Similarly, exports of defence equipment to third countries are, of course, a commercial business, but they are also clearly linked to foreign policy considerations of the different Member States.

The Commission would most likely find itself on a collision course with several, if not all Member States who would strongly resist what they perceived as interference in their sovereignty. Thus rather than improving market conditions, this approach could increase Member States' recourse to Article 296 and slow or halt progress through lack of cooperation.

If progress is to be envisaged at the EU level in the future, possible advances in this field demand a progressive and cautious approach, if they are to have any chance of being acceptable to Member States.

Social impact

Given the obstacles mentioned above concerning the small likelihood that this option could be carried out as proposed, it is difficult to estimate the impact on employment or structural change. However, co-ordination and harmonisation at EU level (for example of offset practices and fair competition) would help to establish a level playing field for the different defence capabilities in the Member States and therefore increase the opportunities to participate in a European supply chain for enterprises in Member States with less developed defence industries than others. This could increase the benefits of more European cooperation in defence for a wider range of companies and hence employees.

This option might also encourage enterprises and employees to adapt and restructure more quickly to stay competitive in a truly European market. While this would produce a stronger, more competitive industry in the long run, it might lead to higher short-term adaptation costs, because the procedures and structures at national level could change considerably (for example with increasingly pooled demand or the immediate phasing out of offsets). It is very difficult to predict which companies in which Member States would have more difficulties to adapt or which would find it easier to restructure, because this would depend on future demand for defence goods and the capabilities of companies to adapt to new demand structures. However, companies currently heavily depending on national demand and hence national defence budgets might face more difficulties than those already competing to a large scale on external markets. Such companies might feel heavier pressure to adapt. It is, however, difficult given the diversified structure of industry and of different ownership

structures to precisely predict these effects, which would also have to take into account suppliers that could, in certain cases, be as much if not more affected.

Environmental impact

No material impacts on the environment are expected.

6.3. *Option 3: A step by step approach, intensifying the process with immediate steps where appropriate and working with other stakeholders to identify and prepare further areas of work*

Economic impact

Progress can be made immediately on issues of interest to Member States and industry. For example, in the area of standardisation of defence equipment, work already undertaken has demonstrated that Member States share the interest for interoperability of equipment. This was also welcomed by industry as a condition for competition to operate in a European market.

Similarly, in order to reduce the fragmentation of the market, the two legislative measures presently envisaged aim at, firstly, adapting the Community legislative framework for defence procurement, thus reducing the attractiveness of recourse to Article 296 TEC for Member States and, secondly, facilitating intra-EU transfers of defence goods, thus allowing the development of a truly European market.

The objective of building a strong and competitive EDTIB is also clearly shared by Member States. In such a sensitive area, it is more effective if all actors act at their level and with their own tools in a complementary manner. In particular, EDA activities in this field within the framework of Article 296 TEC call for complementarity with the Commission activities for actions not covered by Article 296 TEC.

This is, for example, the case with defence research (EDA and Member States) and security research (Commission) in order to identify synergies and avoid duplications. This should also be the case in fields touching upon security of supply or security of information, where action taken by the Commission must be supported by action within the EDA.

Although some might regret that the action is not faster, the effectiveness and the efficiency of results achieved in a coordinated approach with all stakeholders seem to be greater.

A progressive approach which is complementary to the initiatives taken by other actors also allows, not only for the identification of the necessary measures, but also, as a consequence, for the identification of the actor best placed, functionally and institutionally, to take those measures.

Social impact

As this option would not lead to short-term dislocation through the immediate harmonisation of all procedures or legislation, efforts to prepare for adaptation and restructuring could be stretched over a longer period and more thoroughly prepared. This option would also allow

for a much deeper participation of stakeholders in the process allowing each of them to adapt their restructuring needs to the rhythm of their own activities and strategic plans. Whereas this option might lead to more cooperation between companies in the EU and, in the medium-term, to changes in the distribution of work shares and employment, it also allows for time to adapt more smoothly, including the suppliers concerned. This is particularly important given the fact that defence companies are often located in areas where other economic activity is low.

Environmental impact

No material impacts on the environment are expected.

7. COMPARISON OF OPTIONS

Specific objective	Option 1: Do nothing	Option 2: Immediate action	Option 3: Step-by-step
a) pooling demand	No change of status quo	A budget line would be needed for the Commission to act	Highlighting dangers of inaction could spur Member States to act in the medium-term as the approach is coherent with that of the EDA
b) pooling R&D	Under spending and duplication would continue	Better coordination of civil/military R&D, but no impact on pooling military R&D where there is no Commission competence	Better coordination of civil/military R&D could also be combined with efforts of EDA and Member States
c) Security of Supply and Security of Information	No change of status quo; voluntary agreements would prevail; inaction would prevent the Europeanisation of the EDEM	Immediate action could be proposed but would be unlikely to progress without first building trust among Member States	Commission would highlight need for action, while in the meantime the legislation on transfers will already help in practice
d) Foster SME involvement in the supply chain	EDA would continue implementing Code of best Practice for the Supply Chain	Commission could offer measures to further increase opportunities for SMEs	Commission could offer measures to further increase opportunities for SMEs
e) Reducing offset requirements	No change of status quo; the continuing distortions resulting from offsets would continue	No progress possible without agreement of Member States; strong action might even intensify their resistance to change	Commission could provide a reasoned analysis of the situation and recall the legal framework. The procurement Directive will also be an important step to create favourable market conditions where offsets may no longer be needed.
f) Make use of standards for defence goods	Ongoing work on standardisation would be stopped and existing work would gradually become outdated	Commission and EDA continue their ongoing work; attempts to impose the use of common standards could increase recourse to Article 296	Commission and EDA would continue joint action to develop and promote the use of standards developed by all stakeholders.

g) Ensure fair competition	No action would make the creation of an EDEM more difficult	Forceful action without further progress towards EDEM would probably backfire by increasing resistance of Member States	Progress on EDEM will increase transparency and trust thereby building acceptance of an increased application of the common rules
h) More balanced trade relations with the US	Given the attractiveness of the US market, business could migrate and trade become even more unbalanced; long-term risk highlighted by EDA that EU companies become sub-contractors of US primes.	It is not expected that early progress could be made without dialogue and greater balance in the opportunities and scope offered by the respective markets	Commission could analyse the situation and emphasise the need to firstly work closer together at EU level before developing together with MS a strategy to help rebalance trade
i) Identify barriers to trade	Identification would happen in an ad-hoc, uncoordinated way and no European perspective	Commission could start to systematically register barriers perceived by Member States and industry	Commission could start to systematically register barriers perceived by Member States and industry
j) Anticipating change	Some Member States would act; however, action at national level might be inadequate to match restructuring needs at EU level	Commission could offer analysis and support measures from a European perspective	Commission could offer analysis and support measures from a European perspective

Conclusion

The above comparison shows that option 3 would not only have the greatest impact on the achievement of the specific objectives but would also avoid the major negative consequences in the longer- and shorter-term respectively, of options 1 and 2. As mentioned in the assessment of impacts in section 7, the sensitivity of the defence sector and the need for stakeholders to act together to achieve the most efficient results, necessitate a careful approach ensuring a wide consensus. Hence, it can be concluded that taking immediate steps in specific, identified and agreed areas and highlighting the need for further steps in other areas seems to be at this point in time the best way forward.

The options analysed above will not entail budgetary expenditure.

8. MONITORING AND EVALUATION

The Commission will evaluate the progress made in 3-4 years. This evaluation will cover initiatives of the Commission, the EDA and Member States, which contribute to strengthening the EDTIB and creating an EDEM as set out in this impact assessment and Communication.

As future legislative actions will be accompanied by separate impact assessments, it does not seem appropriate at this point in time to define indicators for their implementation.

The Commission will also monitor the developments in the defence sector continuously in its daily work with the European Defence Agency. In particular, it will, on a regular basis, conduct a competitiveness study of the sector. Once finalised, the mapping of the European defence industry undertaken as a follow-up of the 2003 Communication, should also improve knowledge and data on the defence industry in Europe.

Annex 1 - The EU defence industry

The EU defence industry is composed of a diverse range of industries and businesses providing products and services to the EU and Member States, both for national security purposes and to provide the necessary support to international organisations such as the UN and NATO. Member States have recently been involved in the stabilisation process in Bosnia Herzegovina conducted by EUFOR and individually within international peacekeeping contingencies established in Afghanistan and Lebanon.

The demands of modern military units often push current technological boundaries, with the defence industry increasingly regarded as one of the principle high-tech industries in the EU, providing advanced technologies, which may be dual-use. Over time, the take-up of such technologies by the civil market often becomes dominant, providing important knock-on employment and value added affects throughout the EU economy. Examples include satellite communications and the internet, both of which have been critical in the economic development of the EU in recent decades. For these reasons, it is important to evaluate the defence industry not just in terms of strategic military and defence objectives, but also in terms of its wider economic and social impacts accruing from innovation, employment and the associated high skills base.

With so many different product and market segments across the traditional defence industry and supplied via commercial companies, it is difficult to accurately define the defence equipment and services market. The sectors of the EU defence industry can be most simply categorised into four sectors: aeronautics; space; land; and naval defence.

In addition to these main sectors, there are other components necessary for the complete manufacture of a defence platform which are referred to as ‘sub-systems’. Sub-systems include the defence electronics, electronic warfare, radar/sonar and propulsion systems used in aeronautics, space, land and naval defence systems.

As with most industries, products designed and produced for a specific purpose can often be procured and applied to similar markets. Military defence equipment is no different, as protective clothing, bomb detection devices and armoured equipment are also used by security organisations in the civil sector, including police forces and private security companies. With the advent of more protective and anti terrorism equipment common to both the military and civil sectors, market definitions and associated statistics have become increasingly blurred.

a) Global Military Expenditure

Globally, military expenditure totals € 800 billion per year. Of this, the USA accounts for nearly half (48%) with the EU-25 accounting for 20% (€ 180 billion). Further detail on those countries with the greatest expenditure is provided in Table 1.

Rank	Country	Spending (\$ billion)	Spending per Capita (\$)	World Share (%)	
				Spending	Population
1	USA	478.2	1,604	48	5
2	UK	48.3	809	5	1
3	France	46.2	763	5	1

4	Japan	42.1	329	4	2
5	China*	41.0	31	4	20
6	Germany	33.2	401	3	1
7	Italy	27.2	468	3	1
8	Saudi Arabia	25.2	1,025	3	0
9	Russia*	21.0	147	2	2
10	India	20.4	18	2	17
11	South Korea	16.4	344	2	1
12	Canada	10.6	327	1	0
13	Australia	10.5	522	1	0
14	Spain	9.9	230	1	1
15	Israel	9.6	1,430	1	0
Other Countries		161.2	-	16	47
World Total		1,001	155	100	100
<i>Source: SIPRI Yearbook 2006, www.sipri.org - note figures for China and Russia are estimates</i>					

b) EU Military Expenditure

For the EU-25 as a whole, military expenditure has remained relatively constant over the past decade at around € 180 billion per year. With reference to the data presented in Table 2, it can be seen that 80% is accounted for by the expenditure of the larger countries (UK, France, Germany, Italy and Spain). Across the EU-25, most countries now spend between 1.2 and 2.2% of GDP on military expenditure. Austria, Ireland, Malta and the Netherlands spend less (i.e. less than 1.2% of GDP), whilst France, Greece and the UK spend more (i.e. more than 2.2% of GDP).

Table 2: Defence Budgets of EDA Member States (2005)

STATE	Defence Spending in 2005 (in m€)	% of total EDA Member States spending
UK	44,20	22.90
France	42,53	22.03
Germany	30,60	15.85
Italy	26,96	13.96
Spain	10,50	5.44
Netherlands	7,69	3.98
Poland	4,64	2.40
Sweden	4,43	2.29
Greece	4,96	2.56
Belgium	3,34	1.73

Portugal	2,53	1.31
Finland	2,15	1.11
Austria	2,16	1.11
Czech Republic	1,84	0.95
Hungary	1,26	0.65
Ireland	0,92	0.47
Slovakia	0,67	0.34
Slovenia	0,41	0.21
Cyprus	0,30	0.15
Lithuania	0,24	0.12
Luxembourg	0,21	0.10
Latvia	0,16	0.08
Estonia	0,16	0.08
Malta	0,04	0.02
Total	193,0	100

Source: EDA: National Breakdowns of European Defence Expenditure

<http://www.eda.europa.eu/documents.aspx>

The next table indicates the size of major European defence companies on a global level.

Table 3: Top 10 European Union Defence Companies

EU RANK	WORLD RANK	COMPANY	COUNTRY	2004 DEFENCE REVENUE (million \$)	2003 DEFENCE REVENUE (million \$)
1	4	BAE Systems	UK	\$20 345	\$17 159
2	7	EADS	Multiple	\$10 506	\$ 8 037
3	9	Thales	France	\$ 8 868	\$ 8 476

4	11	Finmeccanica	Italy	\$ 7 670	\$ 5 896
5	16	DCN	France	\$ 3 547	\$ 2 085
6	18	Rolls Royce	UK	\$ 3 069	\$ 2 490
7	23	Snecma	France	\$ 2 183	\$ 1 846
8	26	Rheinmetall	Germany	\$ 1 883	\$ 2 014
9	27	Dassault Aviation	France	\$ 1 828	\$ 2 009
10	25	Saab	Sweden	\$ 1 900	\$ 1 380

Source: <http://www.defensenews.com/content/features/2005chart1.html>

c) Defence employment

Although definitive data on employment within the defence industry are lacking, there is a general consensus that following the end of the Cold War in the late 1980s, there was a substantial reduction in employment numbers in line with declining defence budgets. This, in turn, led some companies to consolidate or exit from the market. In addition, the skill base has changed from those skilled in traditional engineering of trucks, aircraft and ships, to the more highly skilled workforce, based on R&D, aerodynamics, computer programming, chemistry, physics, etc. required to develop and apply new techniques, materials, designs and systems. The current level of employment within the EU-25 defence sector is estimated to be more than 300,000 employees.

d) Defence turnover of the European defence industry

The following table gives an indication on defence turnover in some sub-sectors (excl. defence systems) of members reporting their numbers to ASD.

Sector	Turnover (€billion)		%
	2003	2004	2004
Aeronautics (military)	26.2	26.7	49%
Space (military)	0.5	0.7	1%
Land Defence	16.6	17.2	32%
Naval Defence	9.4	9.6	18%
Total Military Turnover	52.8	54.2	100%

Source: Based on data presented in, ASD (2005)¹⁵ and ASD-Eurospace (2006)¹⁶.

In terms of trade, military exports account for around 47% of turnover demonstrating the international significance of the EU defence industry as a world player.

¹⁵ “Facts & Figures 2004 “, www.asd-europe.org

¹⁶ “The European Space Industry in 2005”, www.asd-europe.org

e) Defence R & D / R & T

Defence Research and Development (R&D) expenditure are any payments up to the point where expenditure for production of items starts to be incurred. An element of judgement may be required in allocating expenditure between R&D and production costs. R&D costs should also include those for projects that do not successfully lead to production of equipment; and

Defence Research and Technology (R&T) expenditure means expenditure for basic research, applied research and technology demonstration for defence purposes. It does not include expenditure for demonstration or development of products and systems for which a decision to procure has been taken and a service date has been envisaged.

Sector	Expenditure € billion	Expenditure %
Aeronautics (Military & Civil)	10.4	79%
Space (Military & Civil)	0.5	4%
Land & Naval (Military)	2.2	17%
Total	13.2	100%

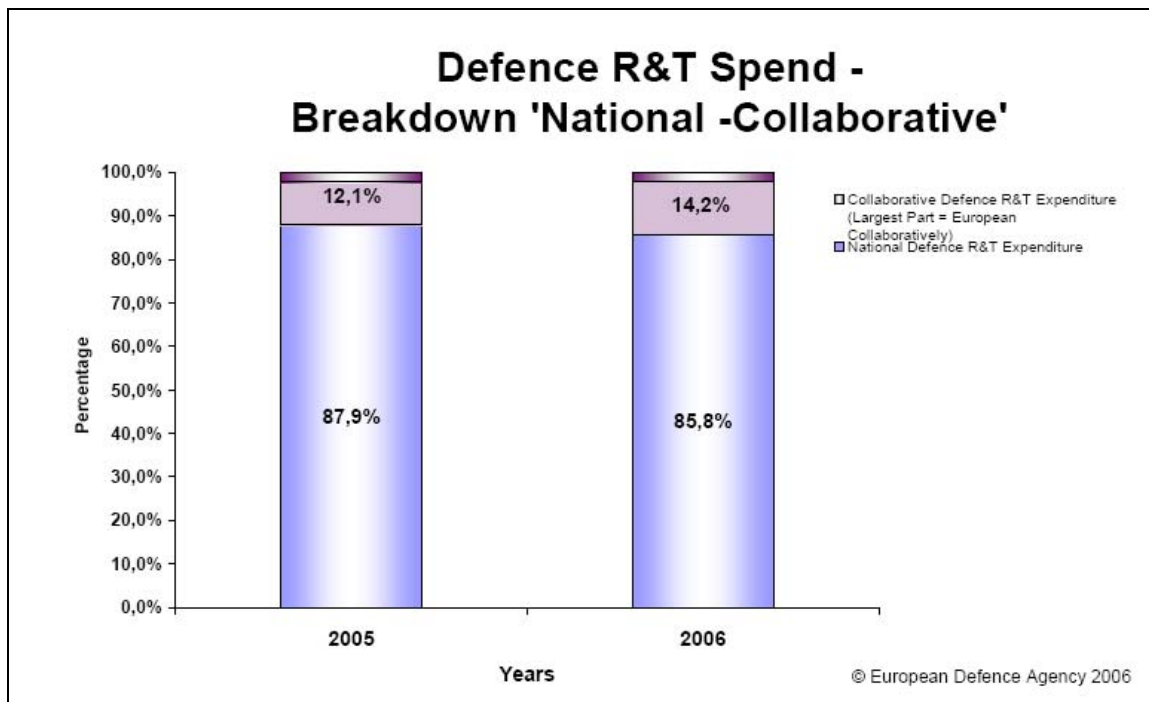
Source: ASD, "Facts & Figures 2004", www.asd-europe.org

The European Defence Agency published in 2006 the R&T data on of its 24 participating Member States:

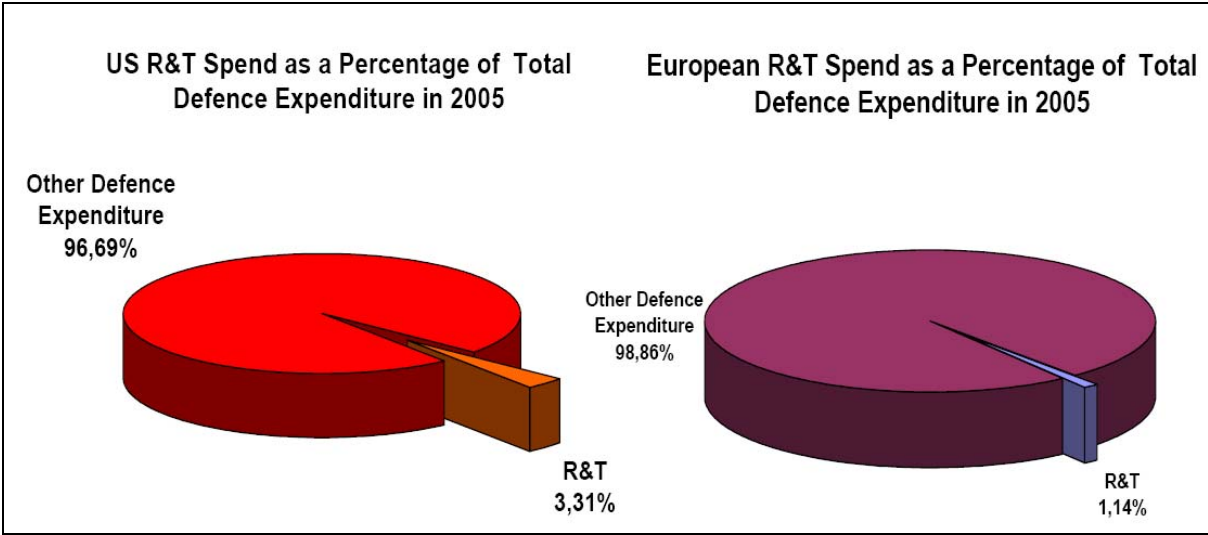
Country	2005			2006		
	R&T (€ m)	GDP (€bn)	%GDP	R&T (€m)	GDP (€bn)	%GDP
Austria	6.5	245	0.003%	7.7	256	0.003%
Cyprus	0.0	13	0.000%	0.0	14	0.000%
Czech Republic	18.6	100	0.019%	18.1	109	0.017%
Estonia	0.5	11	0.005%	1.0	12	0.008%
Finland	32.0	157	0.020%	33.5	164	0.020%
France	695	1710	0.041%	779	1769	0.044%
Germany	297	2241	0.013%	325	2288	0.014%
Greece	1.1	181	0.001%	11.6	193	0.006%
Hungary	0.9	88	0.001%	1.2	92	0.001%
Ireland	0.0	161	0.000%	0.0	174	0.000%
Latvia	0.2	13	0.002%	0.4	15	0.003%
Lithuania	0.2	21	0.001%	0.2	23	0.001%

Luxembourg	0.0	29	0.000%	0.0	32	0.000%
Malta	0.0	4.5	0.000%	0.0	4.8	0.000%
Netherlands	110	506	0.022%	110	526	0.021%
Poland	12.4	243	0.005%	12.4	266	0.005%
Portugal	2.0	147	0.001%	4.4	151	0.003%
Slovakia	2.2	38	0.006%	2.6	43	0.006%
Slovenia	4.5	28	0.016%	24.7	29	0.084%
UK	654	1791	0.037%	654	1877	0.035%
Other (Italy, Spain, Sweden, Belgium)	416	2909	0.014%	379	3047	0.012%
Total	2,253	10,637	0.021%	2,365	11,084	0.021%

Sources: EDA (2006a) and Eurostat (<http://epp.eurostat.ec.europa.eu>); Note: GDP figures for 2006 are forecasts.



Source: EDA



Source: EDA

Annex 2 – List of Abbreviations

ASD: AeroSpace and Defence Industries Association of Europe

CFSP: Common Foreign and Security Policy

EC: Treaty of the European Communities

EDA: European Defence Agency

EDEM: European Defence Equipment Market

EDTIB: European Defence Technological and Industrial Base

ESDP: European Security and Defence Policy

EU: European Union

EUFOR: European Union Force in Bosnia and Herzegovina

GAERC: General Affairs and External Relations Council

GDP: Gross Domestic Product

NATO: North Atlantic Treaty Organisation

R&D: Research and Development

R&T: Research and Technology

SMEs: Small and Medium sized Enterprises

UK: United Kingdom

UN: United Nations

US: United States of America

Annex 3 – Opinion of the Impact Assessment Board and the amendments made in response

Opinion of the Impact Assessment Board

“(A) Context

In the past the Commission has highlighted several times the challenges the European defence industry is facing (communications in 1997 and 2003). The IA report accompanies a further policy communication which sets out the wider context for the European defence and security industry, presents issues of relevance for the competitiveness of the defence industry and indicates directions for possible actions in the near future. In parallel to this policy communication, two concrete legislative proposals (Directive on defence and security procurement and a Directive on intra-Community transfers of defence goods) with separate IAs have been prepared.

(B) Positive aspects

The IA report gives a useful and concise overview about the relevant political and legal context and the available spectrum of actions to enhance the development of the European defence sector. The level and scope of analysis provided is overall proportionate to the political and strategic nature of the document, accompanying the IA report.

(C) Main recommendations for improvements

The recommendations below are listed in order of descending importance. Some more technical comments have been transmitted to the author DG.

General recommendations: While maintaining a proportionate approach, the problem definition should be better structured and the link to the defined objectives should be improved. More attention should be given to recent changes in the regulatory and industry environment and the sectoral scope of the IA report should be clarified.

(1) The set of problems identified should be better presented by grouping the challenges the European defence and security industries are facing along thematic lines. By doing so the report should more clearly say what the key problems are, how they relate to each other and what the competences to act are. The suggestion made by DG ENTR in the course of the Board meeting to group identified problems into framework conditions, market and other issues respectively (possibly combined with a problem prioritisation) appears to be an appropriate starting point. Such an approach should also allow establishing a better and more coherent link to the envisaged objectives and should give a better idea about the types of actions envisaged in the future.

(2) More attention should be given to industry evolution and regulatory changes, particularly those which have taken place since the adoption of the last communication in 2003. This should allow a more complete understanding of the evolving problem context and the policy interplay between the EU's first and second pillar instruments while highlighting in parallel the specific features of the defence sector and related policy agendas.

(3) The scope of the IA report should be clarified. While the title of the IA report relates to both the defence and the security industry, the content seems to relate to the defence industry only. The IA report should therefore align title and content either by clarifying that the

presented analysis is overall relevant for both industry sectors or by aligning the title to the presented content. The IA report should also clarify how the different industrial policy concepts (European Industrial Policy for a European Defence and Security Policy, armament policy and defence industrial policy) relate to each other and should refer to these concepts in a consistent and coherent way throughout the text.

(4) It is recommended to elaborate on the impacts of the various options on employment in the involved industries across the various Member States and also on the potential savings on defence and security budgets of EU governments, taking into account the long lead times of contracts in these sectors.

(D) Procedure and presentation

It appears that for the present type of proposal, the IA conforms to all necessary procedural elements.”

Main amendments made in response

- The problems identified were grouped in three areas: Framework conditions, Market issues and other areas. Accordingly, the corresponding objectives to address the identified problems were grouped in the same way. Instead of providing a short list of objectives, an explanation was added to each objective and it was indicated which measures could be taken to address this objective and which actor could be involved. To visualise the link with the problems identified, the main issues for each of the objectives were highlighted in bold.
- In 1.1, Policy Background, measures taken since the adoption of the 2003 Communication on the defence industry and market were added. To better explain the policy links between the first and the second pillar, the subchapter 1.2., Legal Background, was amended to explain the cooperation between the Commission and the European Defence Agency.
- The focus of the Communication will be on problems faced by the defence industry. Although the security sector is growing in importance and is mentioned in those areas where it faces the same problems, the term “security” was deleted from the title of the Communication to better reflect the content which focuses indeed on the defence industry. The term “armament policy” was also deleted from the text to avoid confusion in the Communication. Furthermore, a subchapter 1.3 to explain the interaction between the general industrial policy objectives outlined in the Lisbon strategy and a defence industrial policy was added.
- Chapter 6, impact assessment: the sections describing the impacts of the options analysed in this impact assessment on employment in the EU were further elaborated. However, given that the Communication is a policy document which does not propose legislative action in itself, the impacts were only qualitatively described to keep the analysis proportionate to the type of document to be submitted to the College, bearing in mind that should any other of the policy options discussed lead to legislation in the future, the latter would be accompanied by a separate impact assessment in the same manner as the two proposals submitted together with the Communication.