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THE CHALLENGES FACING THE EUROPEAN DEFENCE-RELATED INDUSTRY, A CONTRIBUTION FOR ACTION AT EUROPEAN LEVEL

Contents

1. Introduction

The defence-related industries are facing an economic and political context which is changing completely and calls for responses going beyond the national level.

The end of the cold war, considerably reducing the security risk to Europe, has made it possible to cut military budgets and step up the moves to convert the industries concerned. The need for the defence-related industries to scale down their activities substantially has had a significant direct impact, both on employment in this sector which has fallen by 37% from 1.6 million to 1 million since 1984, particularly hitting certain regions, and also on the manufacturing base and innovation capacity of European industry as a whole. Over this period the economic problems have persisted, if not worsened; they stem not only from the cuts in military expenditure but also from the fiercer international competition and, above all, from the anachronic fragmentation of the defence markets in Europe.

A change of attitude in favour of action by the Union is therefore emerging. On the one hand, the crisis in the industry has prompted industrialists and industrial policymakers in the Member States to encourage the Union, particularly the Commission, to assume its responsibilities. On the other, the measures taken on the Western European Union (WEU) and on the second pillar of the Maastricht Treaty have opened up paths for establishing a European armaments policy. In particular, on 30 June 1995 an informal group of EU/WEU experts produced a report setting out options, suggestions and recommendations for such a European armaments policy. In July 1995, Coreper set up an ad hoc interdisciplinary working party to identify areas for action by the Union. To this end, it will have to make recommendations on the follow-up within the Community framework or under the common foreign and security policy (CFSP) and, should the need arise, suggest specific measures without prejudice to the Commission's powers under the Treaty establishing the European Community. This communication is a contribution to this work.

The causes of the difficulties facing the defence-related industries are partly economic and partly political. Consequently, both these aspects must be taken into account when analysing the problems specific to these industries and when formulating possible European action.

However, although a global approach to this subject is clearly important, the establishment of a European security and defence identity is nevertheless a long-term process. On the other hand, the state of health of the defence-related industries is such that unless action is taken in time, there is a danger that whole sectors of the economy involved in defence-related activities could disappear, with further massive job losses, particularly considering the fiercer international competition.
This urgently calls for an appropriate European response.
Moreover, the introduction of mechanisms based on economic efficiency, particularly in procurement policies, will allow more rational use of budgetary resources, yielding very substantial savings.This will entail significant savings for the tax payer.According to a study these savings could vary between 5 to 11 billion ECUS a year.

Setting out from this need for action, this communication places the emphasis on action based on the existing Community instruments and, hence, concerning fields in which the European Community has powers and experience of its own. These means of action could possibly be used in combination with the CFSP. Consequently, they could be implemented in the short term as an initial response to the problems facing the defence-related industries and as a first contribution towards the process of building a European security and defence identity.

The approach followed by the Commission is based on the principles set out in its communication on "An industrial competitiveness policy for the European Union" (COM (94) 319, 14 September 1994).

2. The challenges

In the years ahead the European Union must meet a series of challenges with a view to establishing a European security and defence identity and maintaining a competitive technology and industrial base. The survival of these industries depends on this capacity to put in place a consistent strategy to respond to these challenges.

2.1. Economic and industrial challenges

2.1.1. Industrial structure and trends

The annual output of defence equipment in the European Union is currently worth an estimated ECU 50 billion which is about 3 percent of total industrial output. It is somewhat less than half the US defence industrial output. A growing number of defence-related technologies, components and services have both civilian and military applications. This development has made it increasingly difficult to define the boundaries of "defence-related industry" and has made the isolation of defence from civil industry increasingly untenable. The mix between civilian and defence-oriented activities varies from company to company and from industry to industry. In the European aerospace industry, for instance, defence activities account for about 40 percent of turnover.

The development and production of defence equipment currently directly occupy about 600 000 people in the EU. Another 400 000 jobs are generated indirectly in supplier and service industries.

About 70 percent of defence sales come from the aerospace and electronics industries. However, much of the value-added behind the weapon systems and other defence equipment originates in companies which supply components and subsystems and which are in many cases SMEs.

About 90% of the EU total production of defence equipment is concentrated in some Member States: France, the United Kingdom, Germany, Italy and Sweden.

A substantial part of the European defence industry is public or quasi-public, most notably in France, Italy and Spain (although the degree of state control varies).

The domestic demand for European defence equipment has been falling since 1987 when most EU Member States started to reduce their defence budgets. Total military expenditure fell by 5.3 percent in real terms between 1985 and 1994 as indicated in Table 1 in the annex, whereas the procurement of major weapons fell by 28.5 percent in real terms in the same period as indicated by Chart 1 in the annex. However, EU imports of major conventional weapons from third countries have not declined correspondingly.

The declining demand, particularly from developing countries, has practically halved the global arms market over the last decade according to SIPRI statistics.[1] European industry has maintained a share of one fifth of the world export market of major conventional weapons between the 1984-1988 period and 1993, but the absolute amount has been halved in real terms as indicated by Chart 2 in the annex. Compared to the United States, however, the European Union has been losing ground.

2.1.2. Restructuring and competitiveness

Industrial restructuring is expected to continue with significant capacity reductions though many companies have already taken far-reaching steps.

Restructuring

Conversion of military into civilian-oriented production "at factory level" is not considered a feasible strategy by most companies. Apart from the huge investment costs and difficulties of access for newcomers to established civilian markets, conversion is hindered by the difference between, on the one side, production of defence goods which is driven by technology and government specifications and, on the other side, civilian markets which are mainly driven by price with marketing playing a major role. However, conversion in the sense of redeploying a company's R&D base from defence-oriented work to a technically related field has proved practicable for a number of companies with established non-defence activities.

Some of the overall capacity reduction has occurred through outright liquidation of defence-oriented activities in companies which have chosen either to concentrate on what they define as their core activities or to expand the civilian sides of their businesses.

More often, however, the rationalization of the European defence industrial base has involved some form of inter-company arrangement. Mergers and take-overs have so far mainly taken place within national borders since the obstacles to cross-border acquisitions in the field of defence are still considerable. In the EU examples of national

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[1] The arms trade statistics compiled and published by SIPRI (Stockholm International Peace Research Institute) are partly estimated since the official data do not provide a comprehensive picture.

consolidation of defence-related industries through mergers are numerous.[2] Cross-border acquisitions, like GIAT Industrie's take-over of the Belgian small-arms producer FN Herstal in 1991, remain exceptional.

In recent years the consolidation of the defence-related industry has advanced much faster in the United States than in Europe. Following some "mega mergers" and take-overs, the average size, as measured by arms sales, of the ten largest US defence-related companies is now twice that of the ten largest EU defence-related companies.[1]

Most of the consolidation which has reduced overheads costs, excess manufacturing and engineering capacity has taken place within national borders. The economic gains from further national consolidation are diminishing and appear now to be much smaller than the potential gains from cross-border industrial integration.

Competitiveness

In assessing the overall international competitiveness of the European defence-related industry, export performance, company profitability and technological capabilities might provide some indications about the competitive position of the industry and its constituent parts, but it only makes sense to speak about competitiveness for those companies and products which are actually exposed to international competition.

Compared to the US industry, the EU industry has lost ground and is now exporting less than half as much as the US industry. Many of the shifts in relative export performances are linked to international political events, like the end of East-West confrontation, the Gulf War of 1990/91 and the break-up of the Soviet Union. Changes in national arms export policies, including export subsidies, have undoubtedly also played a role. In this context, the US industry had, thanks also to the political influence exercised to benefit it, started to improve its export performance vis-à-vis the EU industry under the relatively stable international political conditions of the 1980s.

The abovementioned factors also suggest that part of the shift is due to changes in the underlying competitive positions, including the significant depreciation of the US dollar against European currencies since 1985, that put a heavy burden on the competitiveness

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2 - In the UK, a large part of the industry is now grouped around British Aerospace and GEC and further concentration has taken place (the take-over of VSEL - a Barrow-based submarine maker/shipbuilding company - by GEC).

- In Germany Daimler Benz Aerospace plays a key role.
- In Italy the scene is dominated by Finmeccanica.
- In France the national consolidation is more evenly spread between the companies

3 Illustrative examples of the US restructuring and consolidation process are :

- Lockheed's acquisition of General Dynamics' fighter aircraft division in 1993
- Northrop's takeover of Grumman in 1994
- the agreed merger between Lockheed and Martin Marietta in 1994, followed by the acquisition of Loral in 1996
- the recent talks between Boeing and McDonnel Douglas on a possible merger of their civil and defence activities (1995).

of European defence-related companies. The G7 summit in Halifax pointed out the risks that such fluctuations pose to sustainable, non-inflationary growth and the continued expansion of international trade. The EU and US are therefore encouraged to work more actively and address the imbalance of the US dollar versus EU currencies. The conclusions of the recent transatlantic business dialogue held in Seville stressed the importance of fostering better monetary stability.

The strong competitive position of US industry vis-à-vis European industry is best illustrated with figures on defence equipment imports by individual EU Member States, i.e. inclusive of intra-EU trade: 75% of imported major conventional weapons came from the United States in the 1988-92 period. The worsening in the competitive position of the European defence-related industry results also from the bilateral EU-US trade balance for major conventional weapons that was 10/1 in favour of the United States in the 1988-92 period (see Table 4 in the annex).

But export performance cannot provide a complete picture of international competitiveness, particularly in a field where trade and procurement decisions are rarely taken on commercial and economic grounds alone. From a company perspective the important test of competitiveness is profitability.

For the European defence-related companies the picture is mixed in this respect. Quite a few of the large arms-producing companies have lost money in recent years on their defence-oriented activities, some of them over a considerable number of years. Other companies have continued to operate profitably in the defence field and have been rather successful on export markets.

Assessing European industry's technological strengths and weaknesses in the field of defence is also difficult and somewhat subjective. The US Department of Defence has tried to compare US and European capabilities regarding 20 so-called critical technologies. The DoD believes that European industry does not "significantly lead" the United States in any of the sectors but is "capable of making major contributions" in seven sectors.[4]

On an overall industry level the aforementioned trade figures give a strong indication that the European defence-related industry has experienced a worsening of its competitive position vis-à-vis the US industry since the 1980s. For comparable equipment, produced with economies of scale, the US industry tends to have better price competitiveness than the European industry due to a domestic market more than twice the combined size of the markets in the EU Member States and about seven times the largest national European market. This structural advantage of the US industry increases with reductions in overall demand and with technological advances and also with the persistence in the fragmentation of the EU market.

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[4] Machine intelligence and robotics, simulation and modelling, weapon system environment, air-breathing propulsion, high-energy density materials, composite materials, and biotechnology. The 20 critical technologies are listed in Table 5 in the Annex.

2.1.3. Market fragmentation and barriers to cross-border integration

Market fragmentation

Since competitive strength is related to the ability to exploit economies of scale, the competitive position of the European defence-related industry, as described above, can partly be explained by the fragmented state of the European market for defence equipment. This fragmentation reflects the widespread and long-standing practice of Member States to favour national suppliers or, should these be lacking, suppliers from NATO countries, in their procurement of defence equipment.

A real European market for defence equipment hardly exists as intra-European trade amounted only to 3-4% of total procurement of major conventional weapons by EU Member States in the 1988-92 period. However, for components and sub-systems the market is more international.

Market fragmentation has generated a number of competitive disadvantages for the defence-related industry in the European Union:

- It has prevented the full exploitation of economies of scale in the production of armaments. The limited size of national orders has made the economic viability of many projects dependent on uncertain export contracts.
- The lack of serious competition for many domestic defence contracts has given rise to inefficiencies in the development and production of weapon systems. This is particularly the case when contracts are awarded on a cost-plus basis - a contract form which, however, is increasingly being phased out.
- In international cooperative programmes, which are more and more necessary for technological and economic reasons, inefficient work-sharing and "juste retour" between countries and their respective "domestic suppliers" have contributed to overcapacities and caused additional costs and have not allowed the integration of national industries on the basis of comparative advantage.

Cross-border industrial integration

Various forms of cross-border industrial cooperation have existed for decades in the defence field: companies from different countries engage in project-specific collaboration and cooperative joint-ventures and, to a lesser extent, strategic alliances (including full-function joint subsidiaries). Collaborative armaments programmes are now the most common way of addressing the prohibitive costs of purely national approaches to the development and production of large complex weapon systems in Europe. The largest European collaborative armaments project is the Eurofighter 2000 in which the major aerospace companies from the UK, Germany, Italy and Spain participate. Another key cooperative venture is developing a new-technology European military transport aircraft for the 21st century within the EUROFLAG consortium. Five countries are currently participating in the Future Large Aircraft programme.

Cross-border joint ventures are another form of industrial cooperation which has become more common in the European defence-related industry since the 1980s. Notable examples of strategic alliances are the relationship between Aérospatiale and Daimler-Benz Aerospace for the development, production and marketing of helicopters (Eurocopter)[5] and the planned establishment of ESI (European Satellites Industry) and EMI (European Missiles Industry) in the field of missiles and satellites or the recent acquisition by Thomson of a 25% stake in the Spanish manufacturer of defence-related electronics Indra.

Joint ventures are typically industry-led, but established with the consent of the governments of the home countries of the companies involved. They may be an effective mechanism for combining the diverse technological capabilities of different companies, but they are less efficient in bringing down development and production costs and in enhancing the overall operational performance of the products. International collaboration with the United States or other third countries is usually a consequence of "off-set" agreements in purchasing contracts with non-producer countries.

The ability of defence-related companies in the EU to rationalize and consolidate their businesses through mergers or sales across borders is restricted by at least five factors:

- Cross-border restructuring of the defence-related industry requires, in most cases, the consent of governments. This is unlikely to be obtained when it is perceived that the national security of supply for crucial defence equipment would be compromised by cross-border rationalization which would reduce the national defence industrial base significantly or make it very specialized.

- The relations between the government and defence-related companies differ considerably between Member States. In some countries a significant part of the industry is owned or controlled by the state, in others there is more distance between them. This disparity is a barrier to cross-border industrial integration which goes further than joint ventures. This situation not only creates distortions at the export level but also affects the development of intra-European policies, particularly industrial cooperation.

- The arms export policies, including arms export control policies, of Member States differ considerably. The attractiveness of a company as cooperation partner depends, among other things, on its ability to gain export licences from its home government.

- Another obstacle is the difference in national requirements regarding defence equipment, including the timing of orders and the strategic concepts for which the equipment is required. Only a joint definition of operational requirements would completely abolish this hindrance to defence industrial integration.

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[5] Euromissile was the first significant joint-venture-like cooperative arrangement in this field. It was set up in 1972 by Aérospatiale and MBB (now part of Deutsche Aerospace).

- Finally, there is a lack of transnational legal structures (such as the European Company Statute) and of recognition of transnational partnerships as eligible for funding under national research budgets.

2.1.4. Technological synergies between civil and defence activities

The action by the European Union to facilitate integration of defence-related industrial activities will have to take account not only of the specific nature of the armaments sector but also of its essential and ever closer links with the civil sector (dual-use technologies, components, products and production installations) in order to encourage the development of technological and industrial synergies between these two sectors at European level.

Traditionally it has been argued that defence R&D generates externalities in the form of innovations for the benefit of the civilian side of the economy (the "spin-off" effect). Since the 1960s, however, the relationship between defence and civil activities has changed: the defence-related industry is increasingly relying on the technological dynamism of the civil sector by making more use of the technologies, components and products of civil origin (the "spin-in" effect). With defence R&D and production making up a smaller and smaller part of high technology activity, technological performance is coming to depend increasingly on firms' success in managing the interface between civil and defence technology. They have to become more adept at assimilating civil hardware and software into defence equipment, at organizing R&D programmes around dual-use technologies and at transmitting knowledge and expertise across the civil-defence divide.

Defence-related companies which operate in both civil and defence markets have an interest and important role to play in exploiting civil-defence synergies. A growing number of them are doing so, overcoming the separation between their civil and defence activities; but still too often, such separation remains an impediment to synergies in companies which have entered into European strategic alliances for their civilian activities but not yet for their defence-related activities. Furthermore, inter-firm synergies need also to be encouraged within and across borders.

The promotion of a dual-use approach has been, for several years, a major objective of US research and defence procurement policies, and is leading to a more integrated defence-civil technology and industrial base. The overall European defence R&D effort, which accounts for only one third of that in the US, is decreasing and comparatively more fragmented. It is therefore essential, if Europe is to preserve a technology base and a research capability (particularly its teams of researchers) which are competitive and sufficiently autonomous, that not only the efficiency of its defence R&D efforts is improved through more systematic cooperation and greater interdependency, but also that it derives maximum benefits from its civil R&D efforts through increased civil-defence synergies.

Action is being taken, to different extents in different Member States, to promote technological synergies between civil and defence activities. This needs to be pursued and strengthened, including at the European level, to optimize the overall use of R&D

resources and to facilitate the restructuring or diversification of defence-related industries. One good example of such convergence is space-related activities. One good example of such convergence are space-related activities. The space industry displays a great degree of common ground between military and civil applications. In that respect, the US industry has long benefited from defence programmes as a springboard into commercial applications in space. The desirable synergies, which are of great importance to Europe, will be identified in a forthcoming communication on space.

2. 2. Political and security challenges

2.2.1. The European security and defence identity

The changes in the international context and the strategic prospects opened up by the end of the cold war call for a review of all the leading players' security policies. A process of restructuring defence has started at both national and multilateral levels. In the long term, this process should ensure better use of security resources and a parallel massive reduction in defence budgets.

Europe's security depends on western European countries' capacity to form a centre of stability and integration. On the one hand, the spread of economic well-being and the gradual admission into the European Union of all European countries which wish to join are key ingredients of stability through integration. On the other, the progress made by the Union towards establishing a fully fledged common foreign and security policy is the second keystone for such a centre of stability. Deepening of the European Union, to include a defence policy in the long term, is therefore a priority. Close cooperation on armaments is a key factor in defence policy. The Union must not only implement a common foreign and security policy but also develop an armaments policy, all the more so since some of the Member States are amongst the largest producers, exporters and buyers of defence-related products.

In this context, Community instruments, adjusted if need be, could be used in respect of the defence-related industries. These instruments could, in particular, be adapted in the light of the security needs and of the political guidelines to be defined within the framework of the CFSP.
One positive development is that the end of the cold war has made it possible to cut defence budgets. However, in the long run the need for the defence-related industries substantially to scale down their activities, though the efforts for reconversion toward civil activities, had directs effects on unemployment losses especially in some regions.And if the required adjustments for the restructuring are not put in place, other consequences could manifest themselves in the long run in the form of impowerishment of the production base and the innovation capability of the european industry.

Maintenance and reinforcement of the sufficiently autonomous, competitive industrial and technology base which Europe needs in order to implement its common defence policy inevitably entails integration of the defence-related industries. This rationalization will allow more efficient cooperation for both the development and the production of military hardware. European undertakings will become all the more efficient and

competitive if they develop synergies, cooperation and even restructuring on the single market.

The EU must foster the development of its own base for the technologies and products essential for defence in Europe. Consequently, it must endeavour to secure comparable, effective access to markets in third countries, which would reduce the one-way dependence on the third countries.

Completion of a European market in defence-related products should improve the efficiency of this sector and, consequently, cut costs for purchasers. Defence authorities' budgets will therefore benefit. However, they must ensure that the market offers them products in line with the duties assigned to their armed forces.

Increasingly, Europe will have to develop its operational capacity to prevent and manage conflicts. As provided for in the WEU's June 1992 Petersberg Declaration, in addition to its contribution to common defence in accordance with the NATO and WEU Treaties the WEU's tasks consist of keeping and restoring the peace, evacuations and humanitarian aid operations. These call on the European and national organizations concerned to plan and develop the appropriate equipment.

The long process of building a European security and defence identity has already begun. The Treaty on European Union and its annexed Declaration on Western European Union provide a means of taking account, at European level, of the political and security constraints which must shape all action on the defence-related industries. To this end, one important point to note is that the CFSP already provides a framework and instruments which could contribute to defining the context and priorities for such action. The WEU is developing its own resources with the objective of giving Europe's defence effective operational capacity. It is therefore essential to ensure a degree of parallelism between the EU's and the WEU's work.

2.2.2 The Intergovernmental Conference

The Intergovernmental Conference starting at the end of March 1996 will discuss, *inter alia,* developments concerning common security and defence policies, including the armaments aspects. Certainly, this does not necessarily mean waiting to implement the conclusions of the IGC before taking European action on the defence industry. On the contrary, it will be easier for the IGC to take decisions if the parties involved in the industry are cooperating already and the public authorities have already taken specific action for this sector at European level. In particular, it will be easier for the IGC to provide the means for a European armaments policy if an efficient industry meeting Europe's security needs has been maintained in the meantime. The Westendorp report which has received strong support among Member States, asserts that the Conference should consider how to encourage the development of European operational capabilities, how to promote closer European cooperation in the field of armaments and how to ensure greater coherence of action in the military field with the political, economic or humanitarian aspects of European crisis management.

3. The players and means of action

3.1 The European Union: promotion of the synergies between its various means of action

On the armaments market, supply and demand follow special rules dictated by the exclusive role of the public authorities, which are guided largely by security and foreign policy imperatives. This implies that armament issues could be discussed within the EU's CFSP bodies. However, the economic dimension of armament issues inevitably entails interaction with the EC Treaty. In this context, either the rules already in force, particularly on the single European market, must be taken as the basis for drafting rules specifically for the armaments sector or the existing rules must be applied, taking full account, however, of the specific nature of the sector. Completion of such a single market for armaments will create, in the perspective of the eventual framing of a common defence policy, interdependence between Member States for supplies of defence equipment. This will facilitate security of supply of such equipment between Member States under market conditions.

Although a European market in defence-related products could be established by applying the relevant rules of the EC Treaty and of Title V of the Treaty on European Union, it must also be acknowledged that a single European market implies that it must have its own identity vis-à-vis third countries. This would be created by establishing specific rules concerning the customs union, commercial policy and access to public contracts. In particular, it must be stressed that with this defence-products market with its own identity the European Union would be in a better position to secure comparable, effective access for its products to markets in third countries under mutually advantage conditions. In this connection, once normal conditions have been restored within the Customs Union, transatlantic trade must be developed on the basis of reciprocal liberalization with the objective of strengthening transatlantic cooperation on armaments, including on export limits on "inhuman" weapons (antipersonnel mines). Establishment of such a balanced relationship also implies establishing mechanisms for evaluating the volume of trade and enforcing effective and comparable access to markets in practice, where necessary.

3.1.1 Instruments available within the EC framework

First, the Community authorities have a range of instruments concerning the industrial aspects of armaments. Second and above all, the Community framework offers the possibility of applying binding rules taking account of the specific nature of the sector and guaranteeing legal certainty for all involved and fair conditions throughout the Community market.

In view of the importance of these instruments, this communication places the accent on the means of action available to the European Community which can be implemented in the short term. For this reason, a more detailed analysis of this potential is set out in Chapter 4, taking account of the specific nature of the sector.

These considerations will undoubtedly be an extremely important factor in ensuring that, in contrast to past practice, the Member States no longer interpret the exemptions authorized by Article 223 of the EC Treaty so broadly. In particular, hitherto Article 223 of the EC Treaty has placed limits on the Community framework by allowing exemptions from the provisions of the Treaty for "the production of or trade in arms, munitions and war material". This exemption applies only under particular circumstances and conditions since the same article adds that the national measures on the subject must be "necessary for the protection of the essential interests of the security" of the Member State and must "not adversely affect the conditions of competition in the common market regarding products which are not intended for specifically military purposes." Article 225 lays down, in particular, procedures for the Court of Justice to monitor the national measures taken under Article 223. Moreover, Article 223 states that the national exemptions may apply solely to the products on the list to be established by the Council in 1958. This list was adopted by the Council on 15 April 1958 and has never been changed since. Consequently, Article 223 gives the Member States no exclusive general powers. Instead, it gives them the possibility of invoking an exemption to the discipline imposed by the Treaty under the conditions described above and under the supervision of the Courts.

Hitherto, however, some Member States have interpreted this Article broadly and divergently, accentuating the fragmentation of the European defence market. Exemptions have been applied to a wider range of products without reference to the 1958 list. The Commission has never exercised its powers to take the initiative to amend the list of products. Moreover, many Member States have seen Article 223 as embodying a general principle that all areas concerning national security are not covered by the Treaties. The Commission has always contested this approach, an attitude confirmed by two recent Court of Justice judgments. In cases C-70/94 and C-83/94 the Court gave its ruling on the Community's exclusive powers under Article 113 of the Treaty and dual-use goods. In particular, it found that since full responsibility for commercial policy was transferred to the Community, national commercial policy measures are therefore permissible only if they are specifically authorized by the Community and that a product cannot fall outside the scope of the common commercial policy on the grounds that it is of a strategic nature. On this basis, Article 11 of Regulation (EEC) No 2603/69 establishing common rules for exports allows Member States to adopt national restrictive measures to avoid the "risk of a serious disturbance to foreign relations or to peaceful coexistence of nations which may affect the security of a Member State". Moreover "a measure ... whose effect is to prevent or restrict the export of certain products cannot be treated as falling outside the scope of the common commercial policy on the grounds that it has foreign policy and security objectives."

3.1.2 Instruments available under the common foreign and security policy

The Treaty on European Union created a new situation by introducing a common foreign and security policy (CFSP) which "shall include all questions related to the security of the Union, including the eventual drafting of a common defence policy, which might in time lead to a common defence".

Security is a general concept. It therefore also includes issues relating to armaments. At the same time the Maastricht Treaty introduced the concept of important interests which the Member States have in common. In particular, the Union is gradually implementing joint action in areas where the Member States have important interests in common. In the case of security, these important common interests were identified in preparation for the entry into force of the Treaty on European Union (see the conclusions adopted by the European Council in Copenhagen on the preparatory work on security). This notion of common security interests will make it easier to decide the conditions for implementing the action necessary in the armaments sector within the framework of the CFSP.

In the "Declaration on non-proliferation and arms exports" adopted by the European Council in June 1991 and supplemented in June 1992, the Heads of State and Government expressed the desire for a common approach leading to a harmonization of national policies on arms exports, based on the eight criteria agreed on arms export policies.

At the Maastricht European Council they identified areas where common action could be taken as part of the future common foreign and security policy. These include the economic aspects of security, in particular control of the transfer of military technology to third countries and control of arms exports.

In 1995 the EU took joint action, based on Article J.3 of the Treaty on European Union, inter alia on extension of the Non-proliferation Treaty and on anti-personnel mines. The latter, in particular, included a ban on exports of mines from the Union, based on humanitarian as well as foreign and security policy concerns.

The existing legislation together with the objectives of the CFSP therefore lay the foundation for the EU to evolve a policy and action making the most appropriate use of the instruments available under the Community framework and under the CFSP to the benefit of the defence-related industries.

The European Union has a single institutional framework which ensures the consistency and continuity of the activities carried out in order to attain its objectives while complying with and building on the existing Community legislation. In particular, the Union ensures the consistency of its external activities as a whole in the context of its external relations, security, economic and development policies. The Council and the Commission are responsible for ensuring this consistency. They ensure implementation of these policies, each acting in accordance with its respective powers (Article C of the Treaty on European Union). In an economic area without internal frontiers and with common security interests, consistency demands that the Union institutions implement policies ensuring greater combination of the powers of the institutions in connection with the various pillars of the Union.

3.2. Closer cooperation between the WEU and EU

3.2.1 Relations between the EU and WEU

In the Declaration on Western European Union, as annexed to the Treaty on European Union, the WEU Member States agreed on the need to develop a genuine European security and defence identity and a greater European responsibility on defence matters. The WEU would be developed as the defence component of the European Union and as a means to strengthen the European pillar of the Atlantic Alliance.

At their meeting in Bonn in December 1992 the Ministers of Defence of the 13 countries then in the Independent European Programme Group (IEPG) set up in 1976 decided to transfer the Group's functions to the WEU, in accordance with the objectives set in Maastricht.

The Western European Armaments Group (WEAG), formerly the IEPG, bringing together 13 countries, including 2 non-EU members, was thus set up and attached to the WEU as the body responsible for cooperation on armaments issues within the WEU. The objectives of the WEAG are to open up the national defence markets to competition, to reinforce Europe's technological and industrial base in the defence sector and to bring about closer cooperation on research and development. At the meeting of the WEU Council in Noordwijk on 14 November 1994, the Ministers of Defence from the WEAG countries noted the establishment of an armaments secretariat within the WEU.

As its operational role develops the WEU/WEAG will probably take on activities in fields where the EU is active on the basis of the Community policies. Given that the EU and the WEU/WEAG have common political objectives, where their activities cover the same fields there are clear advantages to be gained from mutual information and closer cooperation, particularly in terms of efficiency, costs and consistency.

Closer cooperation between the EU institutions and the WEAG would be facilitated by building bridges between the European institutions dealing with defence markets. Such synergies and bridges could be established rapidly and pragmatically on the basis of the Treaty of Rome or of Title V (for example, by extending the existing information and consultation procedures between the WEU and the Commission).

3.2.2 European Armaments Agency

The Declaration on Western European Union annexed to the Treaty on European Union provided for enhanced cooperation between the Member States concerned in the field of armaments with the aim of creating a European Armaments Agency. Despite the considerable progress made with defining the Agency's tasks and statutes, the groundwork has revealed that big differences still remain on the principles and priorities of the Agency's activities.

The WEAG's decision establishing the Agency has therefore been delayed. Against this background, the Commission should consider its possible contribution to establishing this Agency and to defining its tasks and carrying out its activities.

In addition, France and Germany have decided to set up a joint armaments structure in 1996 to allow more rational cooperation and contribute towards establishing an efficient and appropriate industrial and technological base. The Ministers of these two countries declared that this move is part of the process of establishing the common security policy provided for in the Maastricht Treaty and, in particular, marks a constructive step towards establishment of the European Armaments Agency.

The Maastricht Treaty stipulates that the WEU "as the defence component of the European Union will formulate common European defence policy and carry forward its concrete implementation through the further development of its own operational role." To this end, for interoperability and cost reasons and in order to fulfil the common security objectives/tasks, increasingly the equipment requirements of the forces participating in the WEU will in turn become common. Definition by the WEU of European forces' operational requirements will mark a decisive step for European armaments policy. In particular, largely common demand for armaments from WEU states would put the EU in a position to define more closely the rules governing the internal market, imports and supplies of military equipment. Here too cooperation between the EU and the WEU is essential.

4. Contribution of the Community instruments and activities of relevance to the defence-related industry

4.1. Internal market and technological base

4.1.1 Public procurement

The Commission is convinced that important benefits could be derived by the defence community from applying procurement procedures largely inspired by those applied in the EU's civil sector.
It recognizes that the specific character of the defence sector, which involves essential national security interests, which may vary among Member States, may require some adjustments to the procedures which are enshrined in the Community's procurement directives. However, it is important that the main features of those rules are applied as uniformally as possible.

Indeed, the procurement regime, which exists in the Community is based mainly on the following principles: a generally applicable non-discrimination and equal treatment principle, competitive tendering, open and transparent procedures based on objective selection and award criteria and an enforcement structure consisting of legal remedies for aggrieved suppliers and an independent enforcement authority which has investigative powers and can seek corrective measures.

According to a study carried out in 1992 for the Commission into the "Cost of non-Europe in Defence Procurement "",defence procurement amounted, in 1990 in the EU to about 65 to 70 billion ECU a year. Efficient purchasing in this sector could result in savings of between 5 to 11 billion ECU per year thereby avoiding the substantial duplication of industrial capabilities in aircraft, helicopters, missiles, tanks and warships in the sector.

These principles have been further developed by the Council in six directives which lay down detailed provisions on procurement of goods, services and public works by public authorities and utilities and minimum requirements as to legal remedies. These detailed rules only apply above certain monetary thresholds. It is important to keep in mind, however, that the abovementioned principles apply to all contracts, regardless of their value. Applying a similar legal environment to the defence sector would enable Member States to take full advantage of the savings delivered by efficient procurement procedures, while being reassured that their partners abide by the same rules and are submitted to the same discipline.

Although the main core of the Community's procurement regime should therefore be applied to the defence sector as well, certain adjustments need to be made in order to take into account the specificity of that sector. The main issues in this regard are the need to ensure the confidentiality of information "the disclosure of which Member States consider contrary to their essential security interests", and the need to maintain guaranteed sources of supply.

The Community's procurement directives provide for three different types of purchasing procedures, i.e. open, restricted or negotiated. Although utilities can freely choose between these three alternatives, public authorities should normally opt for open procedures, unless there are important justifications to use one of the others. The Commission could well imagine that for certain strictly limited defence purchases, public authorities will consider bids only from companies which have been selected beforehand on the basis of *objective criteria* as willing and able to maintain the confidentiality of sensitive information. It is important to ensure, of course, that this selection process is not used as a disguised means of arbitrarily eliminating certain suppliers.

With regard to the necessity to maintain guaranteed sources of supply, especially in times of international tension or war, the Commission feels that the current regime offers sufficient possibilities to take this element into account. First of all the purchasing entity could select suppliers on the basis of their ability to ensure supply under virtually all circumstances. Furthermore they could conclude multilateral contracts, i.e. contracts concluded with several suppliers for one type of product or service. In such a case a hierarchical order would be established between the various suppliers. If supplier one is not able to provide the product within a given time-period the product would be purchased from the next company in line and so on.

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[6] In 1990 defence procurement amounted in the EU to about 65 to 70 billion ECU per year within which expenditure on Article 223 items was estimated at ECU 40 billion.

If a Member State feels that its needs can be fully met by a offer from a non-EU company which makes the best offer for that Member State's money there does not seem to be a compelling reason for the Community to require this Member State to select an offer which satisfies its needs less well for the sole reason that it is presented by a Community supplier. This does not mean, of course, that the third-country supplier will be able to claim any rights to even being considered as a possible supplier. At this stage, the Commission considers that it would be preferable only to apply these rights, including legal remedies, to Community suppliers.

The Commission intends further to explore these ideas, as well as others which may be presented, with the other institutions and with representatives of the Member States, taking into due account the objective of enhancing in a dynamic way the competitiveness of the European defence-related industry. If this leads to legislative measures, it is obvious that these will have to be binding on all Member States.

However, in order to allow Member States some flexibility in extreme cases involving national security, a safeguard clause should be included in those measures. This clause could be used on condition that other Member States and the Commission are informed immediately after the decision to procure without following the common rules. Sufficiently detailed reasons should be given.

4.1.2 Intra-Community trade

The internal market does not only constitute a trade area favouring greater competitiveness, but also provides the environment for stronger cooperation amongst European industries. By facilitating intra-Community trade, the completion of a "European defence market" should facilitate both cooperation and integration in the European defence-related industry.

Regarding the EU framework, the gradual opening of intra-European borders requires a minimum standard of competition policy and in the long term harmonized export rules. Furthermore, it implies especially, whenever possible, the simplification and rationalization of controls on intra-Community trade carried out by States. In view of this objective and in order to coordinate the methods of control and ensure more transparent results, certain Community instruments should be put in place, based on administrative cooperation.

The need to simplify the national control procedures concerning the movement of defence products applies even more when the trade concerned by these controls takes place within the framework of industrial cooperation agreements. However, the principle of mutual recognition recognized in the framework of the EC Treaty could be used as a basis for technical specifications used for the construction of defence-related products, either in an intergovernmental framework, or through a Commission initiative.

At the end of the day, trade within Europe will not only contribute to eliminating distortions of competition, but also facilitate industrial cooperation and integration, whilst still assuring the necessary provisions for the national security of Member States.

4.1.3 Research and technological development (RTD) activities

Although they are focused on civil objectives, Community research programmes, like civil research activities at national level, are increasingly of interest for the defence technology base because of (1) the overlapping and converging technology needs of the civil and defence sectors in a wide range of areas (dual-use technologies) and (2) the leading role taken by the civilian markets in the development of a growing number of these dual-use technologies.

As the competitiveness of the Community industry is a primary objective of Community RTD policy, Community programmes support research in a wide range of dual-use technological areas (production technologies, advanced materials, information technologies, communications technologies, telematics, aeronautics, energy storage and conversion, etc.).

It has been estimated that technological areas of potential dual-use interest account for as much as one third (i.e. about 1 billion ECU per year) of the overall Community research budget. It is therefore not surprising that a number of companies and research organizations known to be active in the defence sector participate in Community programmes and that some Member States are encouraging them to do so. Some of these companies are also being consulted in the framework of the Commission's Task Forces to improve the links between research and industry (e.g. aeronautics).

Community RTD programmes can contribute to the technology base of the defence-related industry in several ways : (1) by strengthening the overall European research infrastructure and scientific base; (2) by supporting R&D projects leading, after further development, to commercial products, processes, standards or improved quality assurance which can also be used in the defence sector; (3) by supporting R&D projects on generic technologies which can lead, after further development, to either civil or defence-specific applications. Furthermore, Community programmes can also support research by defence related organizations to develop civil applications of their defence technologies.

With the growing importance of trans-European R&D cooperation in both civil and defence sectors, it is now appropriate to consider how, and to what extent increased civil-defence synergies can be promoted at the European level with the aim of optimizing the overall use of R&D efforts.
The Commission considers that, while maintaining the civil orientation of Community research programmes, appropriate steps to start addressing these issues should be :

- to establish cooperation links between EC and WEAG research programmes to avoid duplications, to ensure complementarity, and to facilitate optimal use of research results;

- to identify, in cooperation with the WEAG and industry, key dual-use technological areas where European capabilities are weak or not sufficiently autonomous and should be strengthened;

- to determine, on the basis of the experience and knowledge from the above action, whether, how and to what extent dual-use considerations should be taken into account in the preparation of the future Community programmes (Fifth Framework Programme).

4.1.4 Standardization and technical harmonization

Standardization has been transformed in recent years from a marginal policy area to one which is attracting priority attention within European industry as a means of reducing costs and promoting industrial competitiveness. It is recognized to be of strategic importance for the efficiency of the internal market.
Union-wide standardization policies are relevant to the defence-related industry in such key areas as information technology, telecommunications, power supply, laser technology, new materials, aerospace and quality systems and conformity assessment. In many of these areas, civil standardization activity is proceeding faster than similar work organized for purely military purposes and civil standards are becoming more widely used in defence procurement.

Hence, further convergence of civil and military use of standardization, in order to maximize economic benefits and to minimize duplication of effort and the waste of scarce technical expertise, should be one of the main objectives of EU policy in respect of the defence-related industry.

Greater use by the military of the existing standardization mechanisms and company accreditation at international and European level will combine the advantages of lower costs of procurement, greater competition in supply and, in some cases, shorter lead-times in the development of standards.

Although the scope for the use of civil standardization will remain limited or even non-existent in some security-sensitive areas, such as weaponry, in other areas standardization can provide a common basis from which additional, non-standard, requirements may be developed by the military, if necessary. Unnecessary overlap between civil and military standardization work should be avoided for reasons of industrial efficiency and budgetary savings.

In order to promote civil/military convergence in this field, the Commission considers that the following steps would be helpful:

- the conclusion of cooperative arrangements between the European standardization organizations and NATO standardization experts in order to identify areas of common interest of overlap in their current activity, perhaps by means of a joint report;

- identification by the defence authorities within the EU of standardization work already planned in the civil field that could also be of interest to the military, with the possibility of Community support, where appropriate, by standardization mandates;

- the establishment of a system for regular information exchange between NATO with the European standardization bodies in order to minimize the risk of duplication of work in the future.

Examples of such initiatives which have already been launched include developments in the field of CALS (Continuous Acquisition and Life cycle Support) where cooperation between civil and military structures is about to be implemented.
Recent discussions between the European Commission and the European aeronautics industry have taken place to bring about closer integration between military and civil standards.
NATO has also shown interest by setting up a new standardization organization (NSO).
These initiatives would not affect the continued commitment of the Community to ensure that European standardization is based on international standards wherever possible.

4.1.5 Competition policy

In the light of the emergence of a Community market for the defence industry, resulting from common defence programmes, from European alliances and from necessary restructuring, there is a place for the Community competition policy. It can facilitate, thanks to a clear framework and quick decisions, the concentrations and cooperations between companies which do not call into question effective competition. Moreover, rigorous control of State aids will make it possible to distinguish between aid necessary for restructuring, since it accelerates change, encourages research, development and innovation and reduces the social consequences of reorganization, and aid used for defensive reasons that certain Member States might be inclined to use to avoid the necessary structural changes and transfer the production and employment adjustment costs onto other Member States. The control of aid should also provide a means to make sure, in a more effective manner than today, that aid granted to the defence-related industry is not also used by certain companies to subsidize civil production.
In a sector such as the defence-related industry, the introduction of effective competition should therefore result in considerable productivity gains, in the form of cost reductions and increased innovation which could only improve the industry's exporting capacity.

The Commission considers that the legal basis for the Community's competition policy could be used and provide an adequate framework for competition matters relating to the European defence-related industry.

However, the application of competition law to the defence-related industry must take into consideration the specific features of this industry. It must also be consistent with the objectives of other Community policies, be receptive to information and comments from Member States' Ministries of Defence (MODs) in their capacity as main clients of the defence-related industry and allow Member States to take appropriate measures in order to protect national security in addition to those measures which might be taken by the Commission to maintain and develop effective competition. Competition policy in the defence-related industry should be implemented progressively, in fields such as State aids, agreements and concerted practices since, up to the present date, the Commission has adopted a careful approach to exercising its competence in these fields. Finally, it is evident that the Commission will take into consideration, in the operation of its competition policy for the defence-related industry, the manner in which in particular governments of third countries which produce armaments formulate and apply competition law to their own industry.

So far the Commission has approved/notified concentrations (see table in Annex) of defence industries on the following lines:

- For the moment, geographic markets for defence products and services tend to remain national where a domestic supplier exists because MODs still tend to have strong preferences for national suppliers. However, where there is no domestic supplier, then subject to other barriers such as export restrictions and national preferences, suppliers of defence products and services compete with each other world-wide. Consequently, dominant positions by European defence-related companies at world level are not likely to be observed, given the weight of US competitors in this area. Likewise, when the geographic market is national, a dominant position, if any, is normally not strengthened, given that there is no addition of market share, except when the merger concerns two national suppliers.

- When assessing the market position of a firm in the defence industry, account must be taken of the bargaining power of its main clients: the Ministries of Defence (MODs) of the States concerned. MODs generally formulate the operational requirements and technical specifications of armaments. Also, as a consequence of the reduction in national defence budgets, MODs tend to require higher technical specifications with lower levels of manpower and lower overall costs and to be reluctant to bear the risks associated with R&D.

- The Commission considered the general views of the MODs concerned as relevant for the assessment of the operation.

The extent to which a common market for defence equipment is achieved is crucial to evaluate the effects of the merger policy on the conditions of competition. As far as national markets remain, further concentration may aggravate monopolistic inefficiencies

that can extend into civilian areas of business. On the other hand, if progress towards a common market for defence equipment is achieved, and provided that conditions of competition are preserved, business consolidation may contribute favourably to European competitiveness on a global market.

Finally the Merger Regulation allows Member States to take appropriate measures to protect public security [7].This clause which reaffirms Member States' ability either to prohibit a concentration or to make it subject to additional conditions and requirements compatible with Community law, has been used once by a Member State [8].

As regards agreements and State aids, the Commission has always approved the notified operations. The Commission is conscious that cooperation programmes are necessary in the defence-related industry, in view of the size of certain projects which require substantial financing and multiple skills. As far as financing of military R&D by Member States is required, the Commission takes account of the particularities of defence-related activities, namely a high technology base of production, high costs and a very long development cycle, which, to a large degree, require public financing. Concerning aid for rescuing and restructuring firms in difficulty, great attention should be given in particular to social and regional policy considerations.

4.1.6 Structural Funds

A study carried out in 1992 for the Commission on the economic and social impact of reductions in defence spending and military forces on the regions of the Community showed that about half of the regions in which defence-related activity is concentrated are not eligible for assistance under the Structural Funds instruments (Objective 1, 2 or 5(b) regions). Following the revision of the Structural Fund Regulations in 1993, a number of these areas (in UK, France and Italy) were integrated into Objective 2 regions. As a result more than half the defence-dependent areas are now in assisted areas. It is, however, important to note that even in assisted areas, Structural Fund aid is not available for investment in the defence-related industry itself. The role of the Structural Funds is therefore limited to providing general economic development assistance (including aid for conversion) through the Community Support Frameworks in place in the assisted regions and to the KONVER initiative.

In this context, Objective 4 of the European Social Fund and the related Community Initiative ADAPT have established a horizontal approach (i.e without a priori reference to specific industries or sectors) to structural change and its effects on the workforce.Incertain circumstances, assistance is available for measures which help the adaptation of workers threatened with unployment due to industrial change and change in production systems (especially within small and medium size enterprises).Particular emphasis is placed on the anticipation of labour market trends and improving qualifications and employment opportunities for the workers in question.

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[7] Cf. Art. 21(3) of the Regulation

[8] See point 321 of the XXIIIrd Report on Competition Policy

In response to calls from the European Parliament, the Commission adopted Perifra 1 (1991) and Perifra II (1992). These special measures included support for demonstration projects which could serve as models for the conversion of military installations. In conformity with the position taken by the Parliament, the KONVER Community Initiative was adopted in 1993 to assist regions weakened by the decline of defence industries and installations. The annual programme introduced in 1993 has been extended on a multiannual basis up to the end of 1997.
The purpose of KONVER is to provide support for economic diversification in areas heavily dependent on defence-related activities through the encouragement of commercially viable activities not related to defence.
Eligible areas can be located anywhere in the EU, although at least 50% of the 1994-97 KONVER budget must be spent in ERDF assisted areas (Objective 1, 2 or 5(b)). The eligible areas are small geographical regions in which actual or announced defence-related job losses total 1.000 or more since 1990. Other areas heavily dependent on defence can also be accepted as eligible regions taking into account their high unemployment rates, poor environmental conditions, or isolation/remote location.
A full range of conversion measures including the financing of both tangible and intangible investment in alternative economic activities, the modernization of infrastructure in relation to the economic regeneration strategy of the area concerned, and measures in favour of the environment and tourism can be financed through KONVER. The budget for the programme is ECU 130 million for 1993 and ECU 500 million for the period 1994-97. A reserve of ECU 245 million to support product innovation, the development of environmental technologies and SMEs was allocated to the KONVER initiative on 4 October 1995. KONVER was also extended until the end of 1999. Loans from the European Investment Bank are also available.

Also, the possibility and detailed ruled for financing from other EU resources could be examined in the light of the priorities of the armament policy.

4.2. The external dimension

4.2.1 Export policy

In the European Union, national policies on arms exports have traditionally differed considerably, ranging from nearly total ban to a voluntaristic approach, where arms export is considered vital not only for strategic and political reasons but also for reducing unit costs and maintaining a broad defence industrial and technological base at the national level. Not less importantly, assessments of the risk of exports to certain destinations, linked to foreign policy considerations, have traditionally been made on a national basis. The ensuing differences between Member States are not without cost : national concerns about either a too restrictive or too liberal approach of one or more other Member States on arms exports in general, or in regard to specific destinations, have not favoured intra-European industrial cooperation or integration. Differences in export policy thus also impede the development of intra-European policies. As a consequence the development of common policies inside the European Union in order to secure the industrial basis of the sector should be complemented by a corresponding level of harmonization of national export policies and export-control systems.

The European Council has taken a first step towards a common approach on arms exports, by adopting, in June 1991 (Luxembourg) and June 1992 (Lisbon) (in the annex), eight criteria which Member States interpret when deciding on issuing a licence for a specific export. Exchanges of information on the concrete application of the criteria are being conducted between Member States, with a view to harmonizing their interpretation.

Given the difficulties in developping a common basis for the harmonization of arms export policies a gradual process should be pursued following a two steps approach. In a first stage, regular exchange of information between Member States on arms exports (type and quantity of exported material, destination, end-use) should be pursued. In the case of cooperation programmes, which should be encouraged, progress could be achieved on the basis of current experiences, namely by following the principles according to which export rules of the country where the prime contractor is located apply.
In a second stage the establishment should be pursued of an operational system aimed at eliminating the distorsions between the various national treatments. The drafting of such a system should, for it to become effective, take into account the modalities, principles, scope and the possible needs for improvement, based on the experience gained with the establishment of the export control regime on dual-use goods and technologies (see below).

4.2.2 Export controls on dual-use goods and technologies

To resolve one of the most difficult problems hindering the completion of the internal market, i.e. the problem of controls on intra-Community trade in dual-use goods, the Council agreed, after two years of intensive discussions on a Commission proposal, to establish a Community export control system. It is based on two legal instruments, viz. an Article 113 Regulation[9] and a Joint Action under the Common Foreign and Security Policy[10], which together form an integrated system. Both texts were formally adopted by the Council on 19 December 1994 and apply from 1 July 1995.

The objective of the integrated system is to ensure that effective controls, based on common standards, are applied by all Member States on exports of controlled goods from the Community.

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[9] Council Regulation (EC) No 3381/94 of 19 December 1994 setting up a Community regime for the control of exports of dual-use goods, as amended by Council Regulation (EC) No 837/95 of 10 April 1995, OJ L 367 of 31 December 1994 and OJ L 90 of 21 April 1995.

[10] Council Decision 94/942/CFSP of 19 December 1994 on the joint action adopted by the Council on the basis of Article J.3 of the Treaty on European Union concerning the control of exports of dual-use goods, as amended by Council Decision 95/127/CFSP of 10 April 1995 and by Council Decision 95/128/CFSP of 10 April 1995, OJ L 367 of 31 December 1994 and OJ L 90 of 21 April 1995.

Two key features of the integrated system are:

- a common list of dual-use goods and technologies subject to export control by all Member States as well as a list of destination countries;
- common criteria to be applied by all Member States when determining whether or not to authorize exports from the Community.

This system is part of the effort of the international community to reinforce and coordinate export controls over sensitive items. In particular, 28 countries, among which all EU Member States, agreed in December 1995 on the establishment of the "Wassenaar arrangement". This arrangement succeeds the COCOM regime as regards export controls for arms and dual-use goods. There are obvious links between this arrangement and the EU system, which will call for an adaptation of the EU common list of dual-use goods.

In such a sensitive and complex area where internal market, trade, foreign and security policy interests converge, the common export control system cannot be applied overnight. Consequently, a transitional period is foreseen to ensure that the system works effectively. It will be used to strengthen, where necessary, the control systems of Member States and to reinforce administrative cooperation between the competent authorities.
The new system provides for a clear identification (and a common list) of dual-use goods and technologies and serves as a basis for the reduction, and ultimate elimination, of policy differences between Member States.The fact that an export licence issued by one Member State is presently valid throughout the Union, facilitates joint export projects between companies established in the Community.

The creation of a common regime for dual-use export controls is an important improvement in the regulatory framework for the European defence-related industry which will facilitate structural adjustments thereby increasing companies' competitiveness.Therefore the whole system has to be implemented effectively. When making new proposals for a common regime, the Commission will take into account the ruling of the European Court of Justice in case C-83/94 that dual-use goods fall within the scope of the common commercial policy defined by Article 113.

4.2.3 Import duties on military equipment

The common customs tariff provides for the application of customs duties to most military or dual-use civil and military equipment imported from third countries. Only certain products benefit from specific exemptions, generally as a result of GATT negotiations. Individual exemptions from duties have also been granted under preferential arrangements with certain third countries, such as the members of EFTA. However, other military equipment, and dual-use products are in principle subject to customs duties, although the level of those duties has been lowered considerably in the course of multilateral trade negotiations.

It is against this background that the Commission submitted a proposal to the Council in 1988 for a regulation temporarily suspending import duties on certain weapons and military equipment [11]. The aim was a uniform Community response to national defence

[11] COM(88)502 final - OJ C 265, 12.10.1988. p.9.

procurement requirements which had hitherto resulted in certain Member States unilaterally granting exemptions from custom duties. The Commission considered then, and still does, that the tariff arrangements for imported products, even military or dual-use equipment, are the sole responsibility of the Community and that Article 28 of the Treaty therefore constitutes the only permissible legal basis for granting autonomous suspensions. In this respect, the existence of differing national approaches, apart from not being founded in Community law, is incompatible with the very principles of the Customs Union and the Internal Market.

The scope of the proposal for a regulation was defined with the aim of establishing a balance between the desire to facilitate access by national armed forces to the most technologically advanced equipment and the need to take account of the interests of the Community arms industry. It therefore covers equipment which is military "by nature", and parts thereof. During discussions in the Council, a number of Member States asked for the list to be extended to certain equipment which would necessarily imply not only verifying that importation of this dual-use equipment with duties suspended is not likely to disturb the balance mentioned above but also defining what is meant by "military use" in their regard.

These discussions could be resumed within the overall context of this communication in order to establish a list of products benefiting from duty suspensions which is most suited to the various objectives of a European defence policy. This will also contribute, as proposed by the Commission since 1988, to resolve outstanding difficulties, referred to above.

4.2.4 Trade relations

The development of a European defence equipment market, to the extent that it would lead to greater self-sufficiency in different market segments, has potentially far-reaching implications for relations with third countries, and particularly with the United States, which is the main third-country supplier of arms to the European Union Member States.
Exploitation of the Community dimension in defence procurement does not imply unilateral opening at Community level of the defence market to third-country suppliers.
Because of the exceptions in the multilateral trade regime, including the Government Procurement Agreement (GPA) concluded in the framework of the WTO, competitive tendering does not yet apply to purchases of defence-related material by our trading partners. Every Member State will remain free to consider if bids received from non-EU firms should be examined.
Negotiations should be undertaken in order to lay down the conditions under which third-country suppliers could enjoy, in relation to public procurement and other market access issues, the same rights as Community suppliers in the armament sector, based on comparable and effective access to the markets of those countries for EU suppliers, whilst respecting each party's security interests.

5. Conclusions:

The Commission notes that matters concerning the production of and trade in armaments are linked to defence and foreign-policy considerations of Member States and to progress in the development of a European security and defence identity. On the other hand securing a competitive European defence-related industry is also a precondition for a European security and defence identity.

There is therefore an urgent need for recognition of the state of health of the defence-related industry since, if this is not followed by tangible action, there is a danger of aggravation of the situation, leading to massive job losses and the disappearance of technological skills, with serious repercussions in the civil sector.

Numerous questions, particularly concerning the demand side (for example, harmonization of operational requirements) can only be discussed within the framework of the preparations for a European security and defence identity. In the short term, however, the CFSP provides mechanisms and procedures which could smooth the way for urgent measures.

Many other questions, particularly with an impact on the competitiveness of businesses, can be answered within the European Community framework.

In fact a coherent range of Community instruments is available for the establishment of unified markets and competitive industries. The specificity of this industry can be taken into account adequately when implementing the current instruments.
The action proposed in this document could usefully be complemented by measures in the framework of the Western European Union, in particular the establishment of a European Armaments Agency referred to in the WEU Declaration of 10 December 1991.

The Council is requested to give its opinion on the foregoing analysis and on the suggestions concerning the contribution by the Community instruments.

In the light of the Council's work, the Commission plans to take the appropriate action in the form of specific proposals or other suitable measures.

ANNEX

Table 1* : Military expenditure, in constant price figures, 1985-1994

Figures are in US $m., at 1990 prices and exchange-rates.

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
North America										
Canada	11.014	11.233	11.488	11.631	11.536	11.547	10.413	10.482	10.433	10.151
USA	313.307	335.048	331.215	323.860	320.427	306.170	268.994	284.116	269111	252.358
Europe										
Belgium	4.789	4.984	5.017	4.806	4.732	4.644	4.579	3.760	3.571	3.549
Denmark	2.613	2.520	2.662	2.714	2.648	2.650	2.697	2.648	2.653	2.608
France	39.918	41.081	42.284	42.243	42.793	42.589	42.875	41.502	41.052	41.235
Germany	38.824	39.889	40.570	40.242	40.146	42.320	39.216	37.697	33.486	31.258
Greece	4.524	3.861	3.856	4.078	3.819	3.863	3.663	3.808	3.716	3.778
Italy	19.538	20.187	22.699	24.113	24.304	23.376	23.706	23.004	23.187	23.492
Luxembourg	74	78	89	101	93	97	107	111	102	110
Netherlands	7.350	7.461	7.598	7.561	7.636	7.421	7.161	7.088	6.548	6.263
Norway	3.339	3.234	3.442	3.279	3.369	3.395	3.293	3.569	3.385	3.523
Portugal	1.336	1.504	1.563	1.738	1.824	1.875	1.925	1.977	1.914	1.948
Spain	9.058	8.827	9.995	9.345	9.668	9.053	8.775	8.113	8.823	8.141
Turkey	4.011	4.532	4.316	3.802	4.398	5.315	5.463	5.747	6.355	6.173
UK	43.549	42.867	42.561	40.646	40.792	39.776	41.087	37.141	36.312	35.055
Austria	1.644	1.726	1.612	1.546	1.622	1.542	1.550	1.507	1.502	1.513
Finland	1.826	1.975	1.989	2.085	2.058	2.116	2.447	2.499	2.356	2.167
Ireland	556	571	533	530	525	596	623	617	592	613
Sweden	5.234	5.387	5.499	5.573	5.762	5.909	5.540	5.392	5.273	5.260
EC	180.833	182.921	188.527	187.321	188.422	187.827	185.951	176.856	171.087	173.163

Note : This series is based on the data given in the local currency series, deflated to 1990 price levels and converted into dollars at 1990 period-average exchange-rates. Local consumer price indices (CPI) are taken as far as possible from Internation Financial Statistics (IFS) (International Monetary Fund : Washington, DC). For the most recent year, the CPI is an estimate on the first 6-10 months of the year. Period-average exchange-rates are taken as far as possible from IFS.

* From SIPRI Yearbook 1995, pp. 440-441

Table 2: Major weapon procurement expenditure, 1983-92

Figures are in US $m, at constant (1991) prices

	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
North America										
Canada	2.100	2.350	2.226	2.355	2.568	2.521	2.313	2.129	2.020	2.053
USA	68.635	76.442	83.997	90.105	91.461	84.956	84.271	79.337	74.757	66.140
Europe										
Belgium	705	646	615	650	664	583	474	371	379	322
Denmark	448	416	357	349	393	387	344	391	422	430
France	9.613	9.491	9.888	10.305	11.235	11.057	11.347	10.615	10.077	9.869
Germany	7.884	7.805	7.825	8.191	8.218	7.826	7.685	7.545	4.347	3.562
Greece	633	724	681	634	689	987	870	859	773	828
Italy	3.642	3.505	3.946	3.942	4.994	5.075	5.112	4.202	3.967	3.247
Luxembourg	1	1	3	2	3	3	4	4	6	5
Netherlands	1.700	1.774	1.739	1.531	1.367	1.561	1.359	1.344	1.130	1.208
Norway	637	527	834	668	704	619	838	769	727	846
Portugal	76	69	48	104	173	200	238	212	180	131
Spain	1.970	2.591	1.581	2.164	2.565	2.009	1.838	1.214	1.176	1.492
Turkey	411	519	573	847	1.010	888	785	1.103	1.287	1.488
UK	11.467	12.263	12.259	11.505	11.004	10.842	9.575	7.798	8.118	7.359
European NATO Total	39.189	40.333	40.349	40.894	43.021	42.038	40.468	36.427	32.587	30.787
NATO total	109.923	119.125	126.572	133.354	137.050	129.514	127.052	117.892	109.364	98.979
EC member countries	38.154	39.314	38.965	39.416	41.330	40.570	38.865	34.574	30.591	28.470

Sources : NATO, Financial and Economic Data Relating to NATO Defence (NATO : Brussels, annual); author's calculations. Figures for France are based on national data.

Table 3: EU imports and exports of major conventional weapons, 1984-93

Trend-indicator values, as expressed in mio US $, at constant (1990) prices

Year	EU imports	World total	EU exports	World total
1985	2.126	39.713	8.514	39.713
1986	3.118	44.118	8.001	44.118
1987	2.942	46.377	7.372	46.377
1988	4.162	38.585	6.129	38.585
1989	4.827	37.798	7.696	37.799
1990	3.865	30.891	6.160	30.891
1991	5.463	25.527	5.637	25.527
1992	6.190	24.776	4.611	24.777
1993	3.766	24.494	5.108	24.494
1994	3.766	21.725	6.548	21.725

Source: SIPRI Yearbook 1995, p 510-511

Table 4: Imports by EU Member States of Major Conventional Weapons, 1988-92 (in millions of US dollars at constant 1990 prices)

Supplier: / Recipient	USA	F	D	I	NL	UK	Others	Total
Belgium	709	54		69			102	**933**
Denmark	204	12	49			286	43	**596**
Germany	4.279	67			32	80	15	**4.473**
Greece	3.309	1.365	987	15	254	24	244	**6.197**
Spain	3.040	372	30	126		19	159	**3.747**
France	1.577					13	36	**1.626**
Ireland	23			3		30	16	**71**
Italy	494	17	58				119	**688**
Netherlands	1.734		14			3	13	**1.765**
Portugal	449	36	836		43	10		**1.374**
UK	2.074	121	32		33		65	**2.326**
Total EU 12	**17.892**	**2.044**	**2.006**	**213**	**362**	**465**	**812**	**23.795**
USA		3	429	199		543	669*	**1.843**

* Of which at least $ 128 mio from non-EU countries

Source: SIPRI Yearbook 1994

Table 5: Critical technologies

Critical technologies		Dual-use	NATO allies
1	Semiconductor materials and microelectronic circuits	V	2
2	Software producibility	V	2
3	Parallel computer architectures	V	2
4	Machine intelligence and robotics	V	3
5	Simulation and modeling	V	3
6	Photonics	V	2
7	Sensitive radars	V	2
8	Passive sensors		2
9	Signal processing	V	2
10	Signature control		2
11	Weapon sytem environment	V	3
12	Data fusion	V	2
13	Computational fluid dynamics	V	2
14	Air-breathing propulsion	V	3
15	Pulsed power		2
16	Hypervelocity projectiles		2
17	High-energy density materials		3
18	Composite materials	V	3
19	Superconductivity	V	2
20	Biotechnology materials and processes	V	3
Capability to contribute to the technology :			
4	Significantly ahead in some niches of technology		
3	Capable of making major contributions		
2	Capable of making some contributions		
1	Unlikely to make any immediate contribution		

SOURCE : Adapted from Office of Technology Assessment, 1990

Chart 1

CHART 1: EU Major Weapon Procurement Expenditure

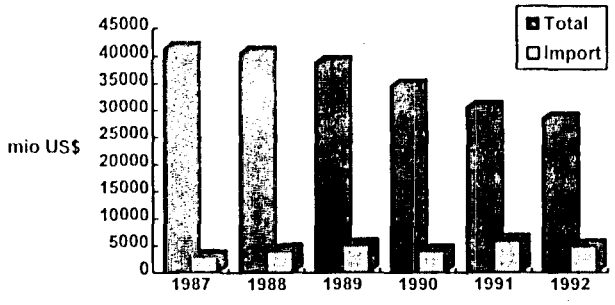


Chart 1 is based on Table 2 on NATO and EC major weapon procurement expenditure, 1983-92 period, and on Table 3 on EU imports and exports of major conventional weapons, 1984-93.

Chart 2

CHART 2: Exports of Major Conventional Weapons

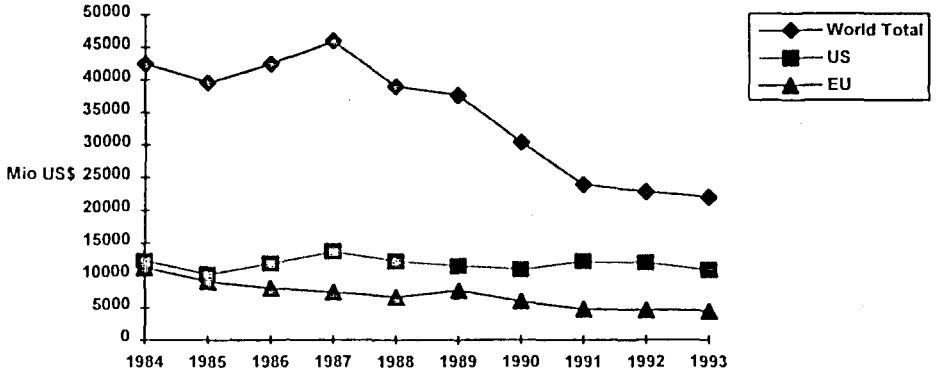
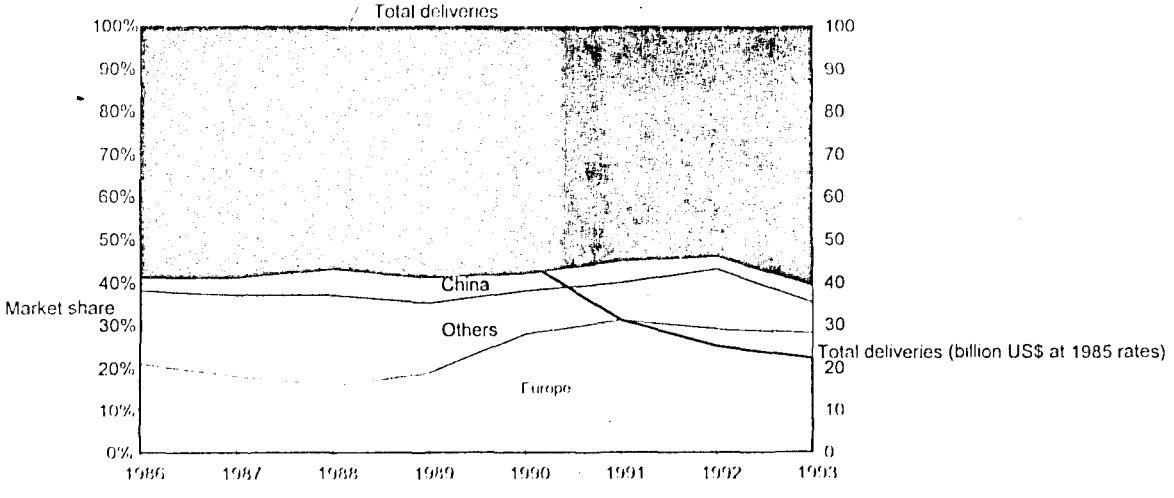


Chart 2 is based on Table 3

Chart 2 bis

CHART 2 BIS : Europe's share of total arms exports



Source : Conventional arms transfers to the Third World 1986-19963, RF Grimmett, Congressional Research Service, Library of Congress, Washington D.C. 1994, pp 87-88

Chart 3

CHART 3: Imports by EU Member States of Major Conventional Weapons, 1988-92

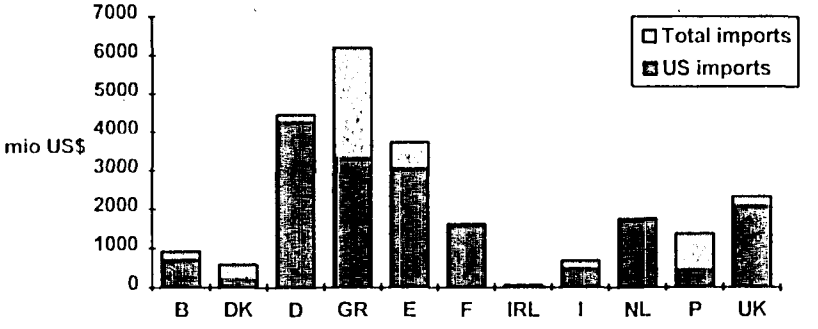


Chart 3 has been derived from the figures in Table 4

Chart 4

CHART 4: EU Imports and Exports of Major Conventional Weapons

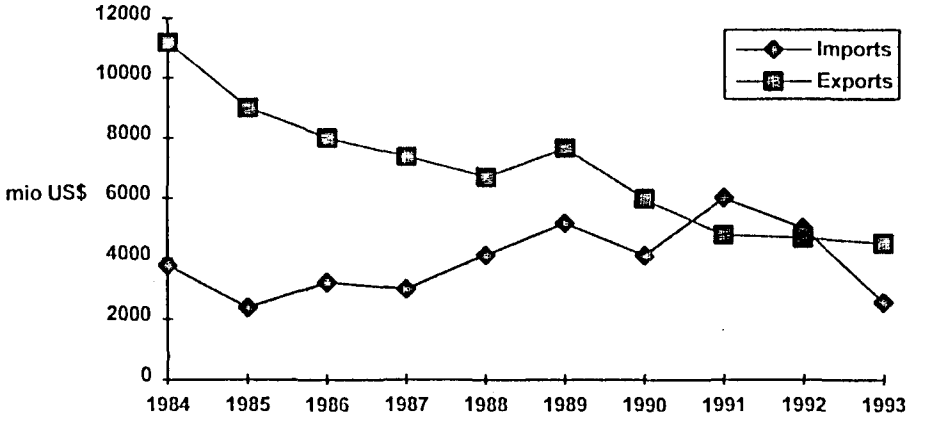


Chart 4 has been derived from the figures in Table 3

List of concentration operations with Community dimension in the defence industry[1] which have taken place since the "Merger" regulation took effect [2]

Reference N° of operation	Companies involved	Nationaly of companies involved	Activities involved	The status with regard to "Merger" regulation
IV/M.17	MBB/ Aerospatiale	RFA/France	Helicopters	approved on 25.2.91
IV/M.86	Thomson/Pilkington	France/UK	Optronics	approved on 23.10.91
IV/M.272	Matra/Cap Gemini Sogeti	France/France	Defence informatics	approved on 17.3.93
IV/M.318	Thomson/Short	France/UK	Missiles	approved on 14.4.93
IV/M.275	Aerospatiale/SNPE	France/France	Missiles engines	not notified under art. 223
IV/M.527	Thomson/Deutsche Aerospace	France/Germany	Propulsion systems for missiles	approved on 2.12.94
IV/M.528	British Aerospace/VSEL	UK/UK	Military shipbuilding	not achieved, not notified under art. 223
IV/M.529	GEC/VSEL	UK/UK	Military shipbuilding	not notified under art. 223
IV/M.571	CGI*/Dassault	France**/France	Defence informatics	approved on 24.3.95
IV/M.598	Daimler Benz/Karl Zeiss	FRG/FRG	Optronics	approved on 27.6.95
IV/M.620	Thomson/Teneo/Indra	France/Spain	Defence electronics	approved on 22.8.95

* Subsidiary of d'IBM
** US for the parent company headquarters

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[1] Only includes operations involving solely or principally production of military material. One can find the same number of operations partially concerning defence material.

[2] Council regulation (EEC) n°4064/89 of 21 December 1989, on the control of concentrations between undertakings, came into effect on 21 September 1990. Only major concentrations with Community dimension are covered by the regulation and these are defined in terms of the turnover of the undertakings involved (see Art 1 of Regulation).