Toward a Fortress Europe?

Dov S. Zakheim

with
Sharon Weinberger

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Contents

Foreword

This paper was written to conclude a series of meetings organized by the CSIS Europe Program between September 1999 and June 2000. These meetings were held in order to examine, assess, and discuss the consolidation of the European defense industrial base and its impact on U.S. industry and policies.

As explained in the pages that follow, this process of consolidation coincides with a major effort by the countries of the European Union to establish a single European arms policy in the context of a European Security and Defense Policy (ESDP). Even as we met, events that would have been unthinkable a few years ago were unfolding quickly and dramatically—including, for example, the establishment of the European Aeronautic Defence and Space Company (EADS) or the ratification of a Letter of Intent (LOI) among six key members of the European Union (EU). Both EADS and LOI, among many other developments, confirmed our assumptions about the course of events in Europe. To understand these events, we invited senior corporate executives from both sides of the Atlantic to lead our discussions.These included, in alphabetical order: Gregory Bradford, president and chief operating officer, EADS; Philippe Camus, co-chief executive officer, EADS; William Denk, director, Defense Programs Division, U.S. Department of Commerce; Anthony Ennis, executive vice president, BAE Systems; Jean Fournet, director for cooperation and industrial affairs, DGA/DCI, French Ministry of Defense; Rainer Hertrich, co-chief executive officer, EADS; Bruce Jackson, vice president for strategic planning, Lockheed Martin Corporation; Jean-Luc Lagardère, president, Aérospatiale MATRA; Susan Ludlow-MacMurray, director, International Security Program, Office of the Under Secretary for Policy, U.S. Department of Defense; Bernard Rétat, vice chairman, Thomson-CSF; Christian Shore, director of international policy, Raytheon Company; and Fred Whiteford, director of strategic planning, Boeing Military Aircraft and Missile Group.

Equally involved were members of various U.S. agencies who attended our meetings, as well as former (and possibly future) senior government officials. These individuals—that is, those who attended at least one of our meetings—are acknowledged at the end of this paper. Former secretary of defense Harold Brown chaired the initial group that was formed for this project, as well as many of these meetings. Former deputy secretary of defense John Hamre also chaired some of these sessions after becoming CSIS president in April 2000. As is the case with many of the activities of the CSIS Europe Program, this project was made possible by the generous support of the German Marshall Fund of the United States. My colleagues at CSIS and I are enormously grateful for the Fund's continued support and extraordinary contributions to the pursuit of an enlightened and sustained dialogue about Europe and U.S.-European relations on both sides of the Atlantic.

Few Americans could write about this question with as much experience, scholarship, and talent as Dov Zakheim. Together with Sharon Weinberger, Dr. Zakheim has produced an important paper that raises a vital question about the future of Europe's relations with the United States—*Toward a Fortress Europe?*—and provides immediately relevant policy recommendations as a new administration prepares to lead this country for the next four years or more. Not the least of these recommendations is that decisions be made expeditiously and in the broad context of reinforced U.S.-EU and EU-NATO relations. We hope that these suggestions will be heard, and that this paper will contribute, therefore, to the unfolding debate over the vital set of questions raised by its authors.

Simon Serfaty
Director, CSIS Europe Program
November 2000

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Introduction

As the Western European Union (WEU) moves toward integration with the European Union (EU), the countries of Europe appear at last to be taking an active role in the rationalization of their defense industrial base and the establishment of a single European arms policy. This process of integration coincides with a major wave of consolidation in the European defense industrial base. The establishment of a joint venture in military aircraft between the European Aeronautic Defence and Space Company (EADS) and the Italy-based Alenia Aerospace is the most recent example of this consolidation. Bringing together defense industries in Germany, France, Spain, and now Italy, seems to be moving Europe closer to the end of a project it started almost 50 years ago.

Whether the EADS merger was EU driven or industry driven is unclear, it nonetheless signaled a strong European commitment to consolidation. Most industry analysts now contend that any further rationalization would have to be achieved through transatlantic mergers. But even without transatlantic mergers, the major defense companies on both sides of the Atlantic would benefit from the market access and cost savings gained from transatlantic cooperation. U.S. attempts to foster such cooperation, however, are out of step with developments in Europe. The most recent change in U.S. export policy, dubbed the Defense Trade Security Initiative (DTSI), addresses only a few aspects of transatlantic cooperation. Most generally, the initiative does not address the growing institutional relevance of policy in European defense industries, or the increasing transnational character of European industry. More specifically, some of DTSI's most radical reforms, such as providing broad defense export exemptions to Australia and the United Kingdom, serve only to reinforce the image of an "Anglo-American" alliance.

Because the EU is still divided on many policy issues, it is difficult to speak about a purely "European" view on defense matters. It is already possible, however, to speculate about where Europe is going. In the case of defense industrial policy, this paper argues that Europe is heading for harmonization rather than unification. This primarily means harmonization of export regulations, procurement policies, industrial policy, and a concerted European effort to invest limited defense resources into the European defense industrial base. The recent ratification of the Letter of Intent (LOI), which encourages transnational defense work, seems to support this concept of harmonization.

Even if European harmonization falls short of a unified defense industrial policy, it may prove just as challenging for the U.S. defense industry. The U.S. understanding of the changes taking place in Europe has been woefully inadequate, reflecting on a broader level the U.S. government's inability to engage with the EU and its structures. Equally important, ignoring further this trend toward harmonization would be conducive to both conflict over market access and damaging effects on NATO and on the Atlantic Alliance as a whole. Debates over the defense industrial base have never been the exclusive domain of market concerns, but affect the entire spectrum of dialogue on transatlantic relations. And while the debate over armaments exports is long-standing, it now seems to be taking on even more importance. The United States should not be concerned only about the prospects of a "Fortress Europe" that harms its economic interests, but also about the possibility of a fractured alliance that hurts the security and economic interests of both sides.

Despite growing industrial consolidation, Europe is still a collection of individual states with respect to armaments policy. The U.S. government's attempts to foster transatlantic cooperation will therefore have to focus primarily on bilateral relations with European states. For the United States to pursue such relations effectively, however, it must also take into consideration the influence of EU politics on each state's actions. It is important to understand how the confluence of defense industrial consolidation and EU harmonization affects the way these states deal with defense industrial policy as a whole. Thus, this paper will look at trends in Europe, whether as a whole or as a group of nation-states, with respect to its defense industrial base and the possibility that the U.S. defense industry could encounter a "Fortress Europe" a few years hence. Because Europe is clearly moving toward greater defense institutionalization, the United States must establish a better understanding of, and relations with, the European Union and its structures.

In this context, the following sections will address defense industrial policy, including European and EU attempts to foster consolidation, with an eye to understanding how these changes will affect U.S. relations with Europe. In particular, this paper will address seven key issues:

- *The factors leading up to integration, and finally consolidation, in the European defense sector.* This section will briefly describe initial efforts at European arms collaboration, which later developed into more comprehensive notions of joint development and procurement programs. Early European collaborative

projects, using principles such as *juste retour,* are illustrative of the way politics often triumphed over economics in early collaborative programs, and influenced later cooperative efforts. This discussion will also examine attempts to encourage transatlantic cooperation, most often through NATO collaborative efforts, and the subsequent decline in these cooperative programs.

- *European initiatives within the WEU to manage the defense industrial base and establish armaments bodies to govern joint procurement and collaborative programs.* Integration has generated a powerful momentum pushing for greater European coordination in the defense industry. This section will take a critical look at the organizations developed under the WEU to foster European defense integration, and the potential for these organizations to affect policy as the WEU integrates into the EU. It will also address European efforts to develop industry-centered organizations outside of the WEU. In particular, this discussion will look at current efforts to expand the Letter of Intent (LOI) and the Joint Armament Cooperation Organization (known under its French acronym OCCAR) and to institutionalize them under the EU.
- *The Single Market and the impact of the EU's evolving role in defense industrial policy.* Since the passage of the Single European Act in 1985, the European Commission has taken on a more proactive role in defense industrial issues, often seeking to use commercial regulation of mergers, trade, and research and development as a way to extend the Commission's control to the defense industrial base. This section will examine some of the most significant results of this expansion, including the adoption of an EU dual-use policy, and efforts to expand EU regulations of arms exports.
- *The development of the EU's role in foreign policy and the impact, direct and indirect, that these developments will have on the defense industrial base.* This section will discuss the Common Foreign and Security Policy (CFSP), the European Security and Defense Policy (ESDP), and the proposed rapid reaction force. Specifically, this section will discuss how the creation of a rapid reaction force will likely influence procurement decisions and arms collaboration. German and French officials often assert that the "rationalization of the defense industry" and creation of a European Armaments Agency would allow the EU to develop an independent European force without actually allocating more resources. Even if incorrect, this assertion underscores the political goals of European procurement policy.
- *Prospects for transatlantic cooperation, and whether cooperation can prevent a "Fortress Europe."* This section will address current trends in transatlantic cooperation and mergers, and some of the problems and benefits associated with these developments. It will review various types of partnership and cooperation, and assess some of the strategic and economic benefits of transatlantic cooperation, including the possibility of a prime-level consolidation of defense. It will also examine the evolving views of senior policymakers on both sides of the Atlantic regarding mergers among prime contractors in light of the growing number of transatlantic mergers at the subcontractor level.

- *The endgame for European defense consolidation: evolution of the defense industrial base over the next five years.* This section will look at both European and national trends in the defense industry, the impact of pan-European alliances and companies, such as EADS and Airbus, and the balancing role played by the United Kingdom through BAE Systems. EADS has yet to prove its financial viability and that it can efficiently consolidate its holdings. Without BAE Systems, EADS still falls short of being a European monolith. Given these factors, fears of a "Fortress Europe" are probably overstated, but a "fortress mentality" could still prove dangerous for the industrial base in both the United States and Europe.
- *Recommendations for U.S. policymakers: How the United States can foster transatlantic cooperation.* This section will explore policy and regulatory change to increase transatlantic industrial cooperation both through reforms to the U.S. export control regime, as well as through developing institutional relations with the EU. At the domestic level, no movement toward transatlantic industrial cooperation is feasible without reforming the U.S. export control regime. Although the United States has taken some of the initial steps in this direction, the reforms lag behind the realities of the European defense industrial base.

Collaboration and Consolidation in European Industry

None of the current discussions over European and transatlantic industrial cooperation are completely new, and it is important to place them in the context of earlier such attempts. Beginning in the 1950s, Western European countries attempted to establish numerous organizations to centralize procurement and correct the one-way flow of arms from the United States to Europe. Thus, the European Defense Community (EDC) proposed as a treaty between France, Britain, Italy, Germany, and the Benelux countries by the French prime minister, René Pleven, in October 1950. Pleven originally conceived the EDC as "a fully integrated European force of small national units under the responsibility of a European defense minister."[1] Had the Pleven Plan been successful, the EDC could have provided a unified procurement base for Europe. This was not to be, however, and four years later, in August 1954, the French National Assembly's failure to ratify the treaty ended the attempt at a supranational armaments body for Europe, which Britain, too, had rejected much earlier. Instead, the U.S.-led NATO became the dominant defense organization in Europe, while the European defense industrial base remained fragmented among competing national defense industries.

Intra-European Collaboration

In the late 1950s, European countries began producing defense equipment such as the F-104 fighter and Hawk missile primarily under U.S. licensing agreements. This type of defense trade, however, limited the development of the European

1. Philip H. Gordon, *France, Germany and the Western Alliance* (Boulder, Colo.: Westview Press, 1995), p. 12.

industry's technological base. As an alternative to dependence on U.S. technology, European countries embarked on a series of collaborative projects in the 1960s. Though these projects were cast as a necessary alternative to dependence on U.S. systems, each state in reality pursued defense industrial cooperation for different political and economic reasons. Britain, for example, suffered from widespread overcapacity in its defense industry and needed collaborative projects to avoid shutting down factories and mass layoffs. Germany on the other hand, with almost no arms industry remaining after World War II, was still in the process of rebuilding its industry and needed both research and development funds. Italy, with its limited defense industry, was eager to join any collaborative projects that could bring in work share so long as it did not overextend the state budget. Finally, France, seeking to maintain influence over the defense sector, played a dual role, at times choosing to remain outside of cooperative projects, while at other times recognizing the role these projects could play in support of its national goals.

Collaboration began with smaller two- and three-country programs, including the Jaguar Fighter/Bomber (UK and France), the Alpha Jet (France and Germany), and the Puma/Gazelle/Lynx helicopters (UK and France), before they developed into more ambitious projects, including in 1969 the Panavia Tornado aircraft, at that time the largest such project ever.

From the beginning, the Tornado project suffered from the usual problems of *juste retour*,[2] which dictates a political rather than economically efficient division of work. The Panavia consortium originally included Canada, Belgium, and the Netherlands, along with the three eventual partners, the UK, Italy, and West Germany. As the estimated costs of the Tornado fighter continued to escalate and schedule delays increased, Belgium, the Netherlands, and Canada withdrew one by one. With their respective air forces already dissatisfied with the compromises made on military capabilities,[3] these governments saw no point in purchasing an aircraft that was not only more expensive than the U.S. option but also less suited for their mission requirements.

Among the remaining countries, work was allocated based on the size of intended orders. Thus, Germany, which had promised to procure over 600 units, assumed the program's leadership with a major share of the work, despite the UK government's contention that British industry had more experience, in both

2. Juste retour dictates that each country receive a share of work approximately equal to the funds contributed to a project (usually through purchase orders). This remains the basis for such projects as the European Space Agency. It differs from traditional offsets in that it operates not to guarantee the return of income, but to safeguard the industrial and technological base in the contributing country. Though long criticized as inefficient and mercantile, it is argued to be the only way to guarantee support for costly projects.

3. For a description of the Tornado negotiations, see Alistair Edgar, "The MRCA/Tornado: The Politics and Economics of Collaborative Procurement," in *The Defence Industrial Base and the West*, ed. David G. Haglund (New York: Routledge, 1989), pp. 46-85.

management and production.[4] Italy, with more modest orders was burdened with a hefty per unit price tag and little work. The end result was an aircraft that was much more expensive than expected, and had little potential market beyond the collaborative partners. The problems associated with the Tornado, however, did not necessarily make it a failure, since the program had political motivations as well. In spite of the economic drawback, the Tornado, arguably, set the groundwork for future collaborative programs.

Focusing primarily on air and ground systems, France, Germany, Italy, and the UK initiated a number of other aircraft and missile programs.[5] Whatever the complications associated with collaborative projects, such ventures were seen by the larger countries as the only way of maintaining a national industrial base. By contrast, smaller countries, such as the Netherlands, often chose to purchase U.S. systems. European collaborative projects presented these countries with higher costs and, with only limited amounts of work share available, offered no more industrial benefits than U.S. licensing agreements. For larger countries, such as France, the UK, and Germany, however, collaborative armaments projects held out the possibility of maintaining their national defense industries, an industrial benefit that offset the higher unit costs.

In some cases, smaller European countries also chose to participate in select European collaborative projects that would help them gain or maintain industrial capabilities in prized defense sectors. The Atlantique marine patrol aircraft, produced in the 1960s by the Societé Européenne de Construction de l'Avion Breguet Atlantique (SECBAT), with industrial partners in France, Germany, Holland, Belgium, and later Italy, is one such example. Although Breguet's (later to become Dassault Aviation) site in France was the main production facility for the Atlantique, Fokker of the Netherlands, and SABCA and FN Herstal of Belgium also participated in the program. The Italian firms Aeritalia & Alfa-Romeo also joined SECBAT in 1968, when the Italian government ordered 18 Atlantique aircraft.[6] Belgium and the Netherlands have also participated in projects to maintain their maritime industrial base, as they did in the Tripartite Minehunter ship collaboration with France. Smaller defense-producing countries were more willing to undertake collaborative programs, so long as they perceived the industrial benefits to their niche industries as outweighing the higher costs of maintaining less-efficient production facilities.

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4. Germany, for example, received much of the airframe and wing work, despite the UK government's claims that British industry possessed better experience and technological capabilities. The award of the variable-geometry wing to German industry meant that Germany would need to import U.S. design technology (developed for the F-111), an outcome that pleased the German government, but one that the British government had sought to avoid. Ibid., p. 67.

5. For an extensive description of European arms collaboration, see Ron Matthews, *European Armaments Collaboration: Policy, Problems and Prospects* (Chippenham: Anthony Rowe Ltd, 1992).

6. Information from <http://frenchnavy.free.fr>.

Transatlantic Cooperation and NATO Arms Collaboration

In addition to European collaborative projects, there was substantial effort to jump-start NATO joint projects. Although coproduction and licensing schemes for NATO armaments date back to the mid-1950s, the emphasis at that time was on U.S. exports to Europe, mainly because the United States was the only nation with the industrial defense capacity to supply large quantities of such equipment. The growing trade imbalance in armaments, both in terms of sales and technological sophistication of weapons systems, prompted European complaints about the one-way flow of arms that reached critical proportion in the 1970s.[7] As a result, European defense companies lagged behind the U.S. defense industry and were unable to provide interoperable equipment for NATO in an efficient manner. In 1974, Thomas Callaghan's report on "U.S.-European Cooperation in Military and Civil Technology" generated widespread attention, highlighting the wasteful policies of alliance weapon procurement. The report made clear that for Europe to close the procurement and technology gap, the United States would have to procure some of its equipment from European companies, even if it meant less economic efficiency in the short-term.

Spurred by the Callaghan report, which recommended standardization and a meaningful two-way street, both the United States and Europe began to pay more attention to cooperation.[8] In 1975, Secretary of Defense James Schlesinger acknowledged that the United States would have to procure some equipment from Europe to encourage NATO standardization, given the multiple production facilities on both sides of the Atlantic.[9] The Culver-Nunn Amendment to the 1976 Department of Defense (DoD) Authorization Act signaled the first major congressional support for transatlantic collaboration. Culver-Nunn authorized the secretary of defense to waive the Buy American Act "when it is determined that it is inconsistent with the public interest to apply the restrictions of the Buy American Act to DoD's acquisitions for public use of certain supplies mined, produced or manufactured in certain foreign countries."[10]

The U.S. government continued to push for cooperative programs throughout the 1970s, and such programs continued over the next few years, albeit with mixed success. Cracks were beginning to show in the collaborative process. First, Europeans complained repeatedly about U.S. unwillingness to share or export defense technology in joint projects. In one example, a joint venture between General Electric (GE) and the French company SNECMA was almost cancelled over this dispute. CFM International, the joint venture between GE and SNECMA to build

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7. At a NATO defense ministers meeting in May 1975, British defense minister Roy Mason called for an intensive effort to identify items that the United States could purchase from European firms. Gardiner Tucker, *Towards Rationalizing Allied Weapons Production*, The Atlantic Papers (Paris: Atlantic Institute for International Affairs, 1976), p. 22.

8. Michael L. Moodie and Brenton C. Fischmann, "Alliance Armaments Cooperation: Toward a NATO Industrial Base," in *The Defence Industrial Base and the West,* p. 27.

9. Tucker, p. 21.

10. *International Programs Security Handbook*, Office of the U.S. Secretary of Defense, 1993. Online at <http://www.fas.org/sgp/library/ipshbook/index.html>.

the CFM-56 aircraft engine, was first proposed in 1969, but it took over four years for the U.S. government to allow engine integration and testing to take place in France.[11] Ironically, CFM International, and its engine, the CFM-56, became one of the most successful examples of transatlantic partnership—the engine is now used by over 250 military and commercial customers, and the joint venture has netted sales of more than $60 billion since it began operation.[12]

Nonetheless, U.S. congressional support and funding began to evaporate at the end of 1970s, as debates over burden sharing began to overshadow talks of collaboration.[13] During the mid-1980s the U.S. government became more concerned with modernizing its own forces than with developing a two-way street with Europe.[14] The growing rift in the alliance demonstrated that European attempts to build its own industry and remedy the trade imbalance would be met with serious resistance from the U.S. side, which already questioned Europe's commitment to NATO. Each U.S. attack on the European commitment to NATO resulted in new European complaints over the one-way flow of arms, and progress in this regard came to a standstill.

The Return of the European Model

While transatlantic cooperation remained stagnant, growth in European cooperation marked another major evolution of the European defense industrial base. The 1980s and 1990s in Europe were characterized by a proliferation of teaming agreements and strategic partnerships, later followed by transnational mergers. In many of the initial stages of industrial cooperation, national policies and the desire to protect the industrial base from U.S. imports guided the process. As the industrial partnerships matured, however, European industry began to play an increasingly important and influential role in fostering additional European cooperative projects and, eventually, in transnational consolidation.

In part because of the rising unit costs of weapons platforms and the inability of national governments alone to procure such platforms in economically efficient large quantities, aircraft and missile programs became popular joint European projects. Some of the projects were ill fated, such as the BAe/Thomson-CSF attempt at a joint venture called Eurodynamics, which failed in 1991 because of financial disagreements between the two companies. Other joint missile projects were successful, such as the Thomson-CSF/Shorts Brothers pairing in 1993 to

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11. The State Department initially vetoed GE's license request, citing technology and security concerns. The Nixon administration effectively overruled the State Department after a meeting with French president Pompidou in 1973.

12. Gus Weiss, "The Jet Engine that Broke All the Records: The GE-SNECMA CFM-56," *in Case Studies in Technology Transfer and National Security*. Online at <http://www.loyala.edu/dept/politics/intel/cfm-56.html>.

13. In 1977, NATO adopted a policy that required each member to increase its defense budget to 3 percent per year. Although the 3-percent goal was not adhered to by most European NATO countries, the policy itself created major debates over the fair distribution of responsibilities on both sides of the Atlantic.

14. Moodie and Fischmann, pp. 25-45.

develop the Very Short-Range Air Defence (VSHORAD) missile system.[15] In the aircraft sector, the like Tornado program partners, Britain, Germany, and Italy, along with Spain, embarked in 1986 on another ambitious project, the European Fighter Aircraft (EFA), dubbed the Eurofighter. Like the Tornado project, the Eurofighter project has experienced repeated delays and cost overruns. The real test of the Eurofighter's success, however, will be if its export version, the Typhoon, is able to compete on a par with U.S. aircraft.

To be successful, joint European aircraft projects require large numbers of export sales because, even combined, the partner countries have not created sufficient demand for large orders that would help reduce the high production costs. The European partners have recognized that export sales are key to achieving cost savings, since higher production rates tend to lower unit costs.[16] The Eurofighter consortium, for example, has estimated that as many as 800 aircraft beyond the 620 ordered by the nations involved could be sold as exports. France also has pursued an ambitious export policy for its Mirage and Rafale aircraft, allowing it to pursue some projects independently. Collaborative projects subsequently copied this strategy.

While both intra-European and transatlantic cooperation were on the rise between 1976 and 1990, there was a drop-off in transatlantic projects beginning in 1991 (see figure 1). NATO projects were particularly on the decline, symbolized by the notable failure of such projects as the NATO Frigate (NFR-90).[17] The decline in transatlantic cooperation is partially explained by the end of the Cold War and the concomitant drop in U.S. defense spending, limiting monies for all projects, including transatlantic ones. What is notable, however, is that *intra-European* collaboration continued to rise at a steady pace during the 1990s, in spite of overall declining defense budgets.[18] By the end of the 1990s, Europeans could point to a multitude of collaborative programs, including the Tiger Attack Helicopter, Trigat Missile, COBRA Radar Program, and NH-90 Helicopter.

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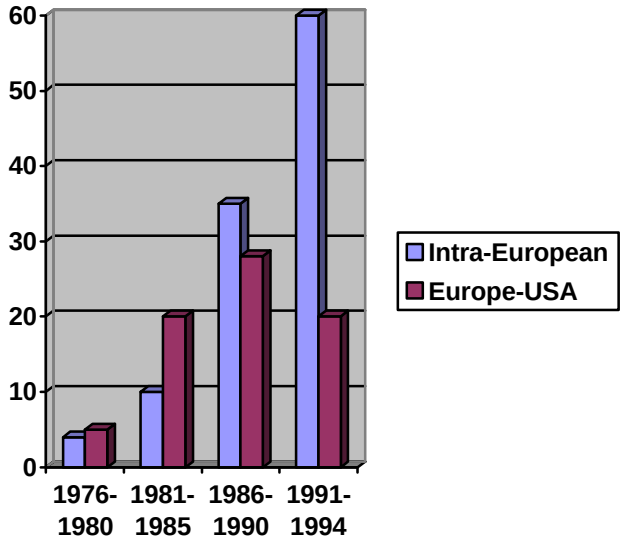
15. For the VSHORAD project, Shorts Brothers' Starburst missile was combined with Thomson-CSF's Aspic fire unit to produce a Land Rover-mounted system for the UK Army in 1997. The missile system was cleared for export by the British government in late 1998. Christopher Foss, "New Starstreak Missile Launched for UK Export Sales," *Jane's Defence Weekly*, September 9, 1998. Shorts Missile Systems, now a wholly owned subsidiary of Thomson-CSF, announced its largest missile contract ever, a EUR 320-million order to supply the UK with Starstreak missiles. "Thomson-CSF Becomes Sole Shareholder of Shorts Missile Systems," *Thomson-CSF Press Release*, December 23, 1999. Available at <http://www.thomson-csf.com>.

16. Unlike the Tornado, the Eurofighter is not just for European markets, but expects to profit heavily from Middle Eastern and Asian sales. Andrew Lathan, "Conflict and Competition over the NATO Defence Industrial Base: The Case of the European Fighter Aircraft," in *The Defense Industrial Base and the West,* p. 101.

17. The NFR-90 was an eight-nation collaborative project to build a common NATO warship. It collapsed in 1990 over differing requirements of the eight partner nations and the lack of a single decision-making entity to manage government and industry conflicts. See UK Defence Forum, "Thinking the Unthinkable: Scrap Project Horizon," Grey Paper, GR54, June 1998. Available at <http://www.ukdf.org.uk >.

18. Pierre De Vestel, "Defence Markets and Industries in Europe: Time for Political Decisions?" *Chaillot Papers*, 21 (November 1995), pp. 27-29.

Figure 1. Number of Intra-European and Transatlantic Collaborative Projects, 1976–1994



Source: Defense Budget Project (DBP) Globalization Database

European cooperation, though extensive and growing, has also been fraught with problems typical of politically motivated collaborative projects. In July 2000, the UK announced the long-expected withdrawal from the Trigat antitank missile project. The reasons for Britain's withdrawal were numerous—the project was ten years behind schedule and had massive cost overruns.[19] The most troubling aspect of the Trigat program was that the interminable delays made the program itself obsolete—the original conception no longer conforms to the needs of the modern battlefield. Nor is Britain the only country that has threatened to pull out; the Netherlands, too, is threatening to pull the plug, in spite of German and French objections.[20]

Even while some government collaboration programs have failed, the programs often set the stage for industry alliances, and some of the military codevelopment programs led to spin-offs into other ventures, such as the formation of the Eurocopter company from the Tiger helicopter project. Formed from helicopter units of Aérospatiale and MBB/Deutsche Aerospace (now DASA) in 1992,

19. Alexander Nicoll, "Britain pulls out of European anti-tank missile venture," FT.com, July 28, 2000.

20. The Netherlands had put in approximately U.S.$30 million for the Trigat program. The real problem, however, is in procurement, with Dutch sales earmarked at U.S.$270 million. "Netherlands Threatening to Abandon Trigat Program," *Military Procurement International*, vol. 10, no. 5, March 1, 2000. Online at <http:/www.dapss.com/MPI/issue0500-netherlands.htm >.

Eurocopter is now the world's second-largest helicopter producer. As a commercial venture, Eurocopter met with success in export markets as well as in Europe. Success in market penetration does not necessarily equate to cost savings, however, as Eurocopter continues to suffer from production inefficiencies and cost overruns.

Eurocopter reflected another notable trend: the expansion of commercial collaboration outside of government programs.[21] European defense companies began to take the lead in developing collaborative projects, strategic alliances, and later joint ventures. European private ventures like Eurocopter and the Apache standoff missile project involving Aérospatiale, Matra, and DASA demonstrated that companies were willing and capable of joining forces to produce marketable defense products without government-led initiatives.[22] With European governments warming to the idea of defense restructuring, and private companies recognizing the benefits resulting from cooperation, the stage was set for the consolidation race of the 1990s.

The Early 1990s: The Race for National Consolidation

European consolidation in the 1990s came about through a convergence of industry pressures with political will and the recognition on the part of European governments that they could no longer "go it alone," particularly in light of drastic and ongoing post–Cold War defense cuts. Following global trends in the arms industry, particularly in the U.S. defense industry, European defense companies finally began laying off employees and closing factory sites. Their downsizing activities were not nearly as drastic as in the United States during the same period, predominantly because of European labor laws and the influence of European labor unions. Among the larger companies, British Aerospace cut 6 percent of its work force between 1988 and 1991, Dassault Electronique 17 percent, and MTU (DASA) 1 percent.[23] A few companies experienced net gains in employment during the early 1990s, such as SAAB Aircraft in Sweden and Thomson-CSF, but these employment gains reflected acquisitions of defense units from other companies. By comparison, during the same period, major defense companies in the United States, such as Lockheed and General Dynamic, were cutting up to 26 percent of the workforce.[24] Consolidation and rationalization was taking place in Europe several years behind and at a much slower rate than in the United States.

For European governments, this meant difficult choices. For mergers to proceed, European governments had to give up, at least to some extent, the notion of maintaining national champions. The governments began to privatize and to reduce or eliminate state ownership and control over defense companies. In some cases, the governments gave up their "golden shares," which had allowed them an

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21. Richard Bitzinger, "Globalization of the Arms Industry: The Next Proliferation Challenge," *International Security*, vol. 19 (Fall 1994), p. 181.

22. Ibid.

23. Herbert Wulf, "Arms Industry Limited: the Turning Point in the 1990s," in *Arms Industry Limited*, ed. Herbert Wulf (New York: Oxford University Press, 1993), p. 16.

24. Ibid., p. 17.

ultimate veto on ownership and control issues, even if they held little or no ownership in a company.[25] Without such reductions of government control, adequate financing for mergers seemed unlikely.

Europe had no political equivalent of the U.S. "Last Supper" of 1993, when Secretary of Defense Les Aspin and then-Deputy Secretary of Defense William Perry informed U.S. defense companies that a shrinking defense budget could no longer support so many prime contractors. Nonetheless, the major European defense companies started their own period of consolidation with a flurry of mergers and acquisitions. In January 1999, British Aerospace (BAe) rejected merger talks with DASA and agreed to merge instead with another large British defense company, GEC's electronics division, Marconi Electronics Systems, creating the single national giant, BAE Systems. Shortly thereafter, in June 1999, France signaled a significant policy change by decreasing state ownership in Aérospatiale, so that the latter could merge with the privately owned firm Matra, resulting in the world's fifth-largest defense contractor, Aérospatiale-Matra.

Just as the consolidation process appeared to be creating even larger national champions in France and the United Kingdom, the German company DASA took the lead in further transnational merger activity. After its merger deal with BAe collapsed, DASA, being much smaller than either Aérospatiale-Matra and BAE Systems and not having another large German company with which to combine forces, had few other choices but to initiate transnational mergers. In June 1999, DASA announced a merger with the Spanish aerospace company, Construcciones Aeronauticas S.A. (CASA). Only a few months later, the DASA/CASA partnership announced that it would merge with Aérospatiale-Matra to form EADS, the largest transnational defense contractor in the world. More recently, in June 2000, the French-based Thomson-CSF completed its acquisition of Racal plc in Britain, helping to consolidate the European defense electronics sector further.

Thus, the European defense industry was recast in the course of one year, with Franco-German–dominated EADS on the continent, BAE Systems in the United Kingdom, and a few other medium-sized companies seeking to establish links to one or both new European defense giants. Additional European merger activity following these large mega-mergers suggests that defense consolidation is yet to be completed. Defense companies in the smaller European nations have begun consolidating into larger industrial groupings. Sweden's two largest defense companies, SAAB and Celsius, merged in March 2000. The Italian government has indicated that it intends to participate in European consolidation through its move to establish ties to EADS through a 50–50 joint venture announced in April 2000.

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25. Golden shares are not, strictly speaking, government-owned shares in a company. A golden share acts as a way to define government interest or involvement in what it deems a "critical area." The golden share is defined as an equity right, stock holding, or in another such prescribed manner. Often, the golden share is not exercised until such time that the company faces privatization, foreign takeover, or other similar changes. In other cases, a golden share is exercised by having a set level of government-designated employees sit on the company board. Golden shares are now being discussed heavily in the EU Commission to see whether some golden-share holdings violate EU law.

It appears that European governments and industry are determined to continue this consolidation activity until they are able to match U.S. competitors.

The Western European Union and European Rationalization of the Defense Industry

Arguably, the most successful examples of defense collaboration have been driven by industry, but European governments have long fostered a political vision of cooperation guided by European institutions. With the failure of the EDC, the WEU was established in 1954 as a much weaker organization. While the WEU remained largely inactive for several decades, it regained strength during the 1990s in part because of the greater EU involvement in the defense sector.

The greatest boost to the WEU's revitalization came at the 1991 European Community (EC) Intergovernmental Conference through a Franco-German initiative to create a separate European Security and Defense Initiative (ESDI) under the WEU. The proposal advocated developing a military force capable of acting independently of NATO, with the eventual goal of linking the European force to the European Community (EC). In turn, the Petersberg Declaration in 1992 provided a mission for the nascent ESDI—it would develop a military force for use in humanitarian, peacekeeping, and crisis management, collectively known as the Petersberg Tasks. Over the next few years, however, little was done to establish an independent force, and the decision was reached at the 1996 Berlin Ministerial Meeting for the WEU to develop ESDI as a part of NATO, or as a way to strengthen the European pillar within NATO. The concept of "separable but not separate capabilities" became the operating mechanism of ESDI under NATO: the WEU could act independently for limited operations, but only by using NATO's integrated command structures.

With the idea of a European military force revived, attention turned once again to the possibility of having a single commonly equipped force. An all-European force could make joint decisions on single arms purchases, thus eliminating duplication and serving the interests of defense industrial consolidation. It was precisely this belief in a "common European weapons market" that spawned efforts in the 1990s to establish organizations under the WEU to facilitate defense restructuring and central procurement.[26] With the idea of a European force still in the initial stages, however, the goal of a single procurement agency proved illusive. Instead the WEU developed competing and often overlapping institutions to deal with different aspects of the defense industrial base.

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26. "[T]he Petersberg Tasks could represent a sufficiently coherent operational framework within which to work out common capabilities and systems requirements, and the corresponding equipment. The creation of a European rapid reaction force will underline the need to standardise the equipment of national armed forces," in Burkard Schmitt, "From Cooperation to Integration: Defence and Aerospace Industries in Europe," *Chaillot Papers*, 40 (July 2000), p. 69.

Organizational Proliferation: From WEAG to the LOI

There had been previous European efforts to address the industrial base, such as the European Defence Industries Group (EDIG), established in 1976, which attempted to provide a European forum to discuss industry coordination and increase government involvement in defense cooperation. EDIG, however, could not get past the long-cherished concept of *juste retour*, which still enjoyed support among many of the participating countries.[27] EDIG, and subsequent organizations, such as the Eurogroup under NATO, had one major shortcoming: they did not actually manage any programs and thus eventually faded into relative obscurity. This set the course for other developments within both the EU and the WEU: an alphabet soup of organizations emerged, each tasked to manage defense, but without any power or money to have an impact.

In 1992, the WEU members created the West European Armaments Group (WEAG) under the rubric of the WEU. As the legal successor to the less-successful IEPG (Independent European Programme Group), WEAG moved to establish a broader agenda of defense cooperation. With no power to contract on its own, however, it became a forum for discussion among the WEU states rather than an empowered body, thus suffering a fate similar to the EDIG. For a time, high hopes were held out for WEAG, especially after being delegated management of EUCLID (European Cooperation for the Long Term in Defense), a program designed to coordinate research among the European countries. Despite the importance of coordinated research to the defense industry, EUCLID followed a pattern quite similar to other joint initiatives. It did not have its own budget, and more importantly, "The program was complementary to the mechanisms concerned with major cooperation programs, but never replaced them."[28] Each country contributed its own funds for national research under the project, thus undermining any attempts at centralization.

These problems notwithstanding, WEAG was often viewed as a precursor to a European Armaments Agency under the EU, as was suggested several times under draft WEU recommendations and, once again, in 1999.[29] A transformed WEAG, under this argument, would be an EU body with a broader legal role, combining theoretical policy debates with actual contractual responsibilities. Paris and Bonn began discussing options for a full-fledged European Armaments Agency within the WEU in 1993, and many WEAG member states, including Britain, agreed to support the agency in principle. From the French and German standpoint at least, a European Armaments Agency would rationalize European industry, allow it to compete with U.S. industry, and encourage the development of an independent European force at lower costs. The idea faded, however, as both countries realized the European Armaments Agency's dilemma: it could involve a few countries and

27. De Vestel, pp. 42-43.

28. Serge Brosselin, "European Military Research in Trouble," *Electronique International Hebdo* (Paris), May 8, 1997, p. 16. Reported in FBIS.

29. The WEU proposal seeks to make WEAG the governing body of such an agency. See Assembly of the Western European Union, *European Armaments Restructuring and the Role of the WEU*, report submitted on behalf of the Defence Committee, Document 1623, November 9, 1998.

delegate real powers, or try to include more countries and have diluted powers. In the end, all sides opted to keep the WEAG arrangement and put off any final decision on a European Armaments Agency.

Too many organizations and too little power is a problem that plagues all of the armaments organizations under the WEU and the EU, and European states remain, as yet, uncommitted to placing real authority in an agency like WEAG. The creation of the Western European Armaments Organisation (WEAO) in 1996 highlights the difficulties involved. Rather than addressing the shortcomings of WEAG, the WEU members chose to found another organization. Established to increase joint research and cooperation in defense armaments, the WEAO was given the limited power to award contracts (two have been signed to date), but similar to previously established organizations, it was institutionally quite weak. At the same time that WEAO and WEAG were floundering, there emerged a real need to have an empowered organization to deal with the increasing number of joint projects and transnational companies.

Frustrated over the lack of authority vested in the WEU, France and Germany sidestepped the entire question of the WEU by creating OCCAR in 1996 as a totally separate agency to manage joint contracts.[30] The UK, fearing that it would be left out of lucrative procurement (in particular, British Aerospace's share of Future Large Aircraft and Airbus contracts) asked to join the Franco-German initiative. Membership, however, had its costs: the UK compromised and agreed to fund part of the Multi-Role Armoured Vehicle (MRAV)—a project it had originally not wanted to participate in—in exchange for being allowed to join OCCAR.[31] This repeated a pattern set by the Tornado project and followed in later negotiations: Britain funded what it considered to be a less desirable joint project in exchange for being let into more profitable collaborations, or as a way to make up for shortcomings in other areas of European policy.

In a way, OCCAR was a positive step in European policy, since it established an authority to manage procurements. From a commercial standpoint, OCCAR provided needed management structure to international programs, simplifying some of the bureaucratic nightmares that had engulfed earlier collaborative efforts, but on a policy level, it has no authority beyond the contracts in manages. Though not yet ratified by the participating countries (France, Germany, Italy, and the UK), OCCAR's board manages several joint programs, including the Tiger combat helicopter, the Milan and Roland missile systems, the Anglo-French Apache air-to-ground missile, and the trilateral Multi-Role Armoured Vehicle (MRAV). OCCAR will also manage procurement of the A400M, the Future Large Aircraft (FLA), one of the largest joint European projects yet.[32]

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30. See United States General Accounting Office, *Defense Trade: European Initiatives to Integrate the Defense Market*, GAO/NSIAD-98-6 (Washington, D.C.: GAO, October 29, 1997).

31. Terrence Guay, *At Arm's Length: The European Union and Europe's Defence Industry* (New York: St. Martin's Press, 1998), pp. 126-128.

32. The participating countries have already committed to purchase 225 units. *Defence Systems Daily*, August 1, 2000. Online at <http://defence-data.com>.

Though some of the joint programs have hit roadblocks, OCCAR has proven more active in the defense field than WEAG.[33] OCCAR superceded the WEU by dealing directly with collaborative projects, and thus avoiding broad policy issues that were more likely to invoke some countries' objections. WEAG would often become deadlocked because members did not want to commit to policy principles without necessarily knowing what impact it would have on actual defense projects.[34] OCCAR, on the other hand, did not threaten any country's sovereignty over military issues, but it could pressure member states to harmonize policy and procurement procedures in order to rationalize project management. As an organization, it proves the point that an organization tasked to manage limited projects is more useful than an organization with a broad agenda and no programs. But OCCAR is not a European Armaments Agency—it can only manage contracts on a limited scale. Unlike the DoD, it cannot make unilateral decisions on procurement and distribution of work. In essence, it deals with one small part of what a centralized procurement agency would handle.

The Letter of Intent (LOI) shares some of OCCAR's characteristics—it is outside of the WEU and was established to deal with specific issues related to multinational projects. The LOI was signed in 1998 by France, Germany, Italy, Spain, Sweden, and the United Kingdom to address the needs of the Airbus consortium and the European Aerospace and Defence Company (EADC).[35] Though it carries no legal authority on its own, the LOI addresses areas crucial for mergers and transnational defense cooperation, including security of supply, exports, research and development, security of information, harmonization of military requirements, and intellectual property. The central focus was on creating a multilateral agreement among the member states that would allow transnational firms to operate as if under one market. Under the LOI, transnational companies would not have to apply for licenses to transfer technical data and defense items among the participating countries, and there would be predefined export destinations for each program.

At the July 2000 Farnborough Air Show, the six members finally ratified the LOI, but the political importance of the LOI will have to be measured over the next few years to see if these changes are accompanied by any EU-wide regulations. In the short-term, however, the LOI is quite significant for harmonizing export policy. Previously, multinational projects such as the Eurocopter had to be

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33. Although outside of the framework of the WEU, other members have already expressed interest in joining. Unlike other agreements (such as IEDG), OCAAR is designed to eventually have decisionmaking authority, if ratified. Under article 39 of the Convention, "OCCAR shall have full legal personality and the power to contract, acquire and dispose of immovable and movable property, and institute legal proceedings." Quoted in Defence Committee Technological and Aerospace Committee Joint Working Group, *Dossier on International Defence Industry Organizations* (Paris: Assembly of the Western European Union, June 15, 1999), p. 8.

34. Once again, smaller countries were concerned that an agency would "buy European," burdening them with an obligation to pay for expensive purchases with little benefit. Guay, pp. 125-126.

35. EADC was to be formed through a merger between DASA and BAE. After the merger fell through, EADS followed with the merger of DASA and Aérospatiale Matra.

negotiated through a separate memorandum of understanding (MOU) that determined handling of exports between participating countries, and exports to third countries were done on case-by-case basis.[36] Under the new "framework agreement" that replaced the LOI, the participating countries will agree to third-market export destinations on a project-by-project basis, while no licenses will be negotiated for exports among the six contracting countries. The ease of moving equipment under the LOI, along with the agreements on intelligence sharing, is meant to increase the efficiency of multinational projects and facilitate further consolidation.

There are, however, nagging questions about the LOI's implementation. For instance, the majority of major European defense projects use some components controlled by the U.S. munitions list—a fact that could prevent the "free transfer" of defense items among participating nations. There is no articulated mechanism in the LOI for dealing with this very real contingency and effort on either the U.S. or European side to address this issue.

Conclusions

The evolution of EU and European defense institutions has certainly been less straightforward than the changes taking place in industry. Nonetheless, a few trends have emerged over the past few years that are worth examining. First, after several decades of floundering, it appears that the transfer of WEU authority to the EU has spurred a process that will enable the EU to establish more powerful involvement in armaments policies. This will be done not so much through the agencies themselves, but through the political drive to push member states to pass uniform legislation in their national parliaments. Second and equally important, the drive toward a common European authority has a dual nature: while for several decades the EU pushed for consolidation in the defense industry, it will now be the defense industry that makes the final push for harmonization of EU policy. This is best exemplified by the parallel existence of agencies: organizations under the WEU, such as WEAG, have fallen into disuse, while agreements focused on industry needs and located outside of the WEU, such as the LOI, have grown in importance.

In a way, these developments should be a heartening trend for Europe; but to move forward, the European states will have to work out a way to combine these overlapping responsibilities under one agency. Even then, a centralized agency would not be the cure-all to resource problems that some foreign ministers have asserted. What is fundamentally lacking, as many critics have pointed out, is a European-level approach to the problem. While OCCAR, LOI, WEAG, and WEAO have overlapping responsibilities and claims to defense industrial policy, there is still little coordination among them.[37]

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36. The LOI would also relieve the burden of transferring components internationally to different project sites, alleviating the need for export licenses. Burkhard Schmitt, "From Cooperation to Integration: Defence and Aerospace Industries in Europe," *Chaillot Papers*, 40 (July 2000), p. 63.

37. Schmitt, p. 80.

The EU and the Single Market: Defense Industrial Policy versus Article 223

For many years, efforts to unify defense industrial policy under the aegis of the EU have been hampered by Article 223 of the Treaty of Rome, which excludes military products from competition in public contracts. Once thought to be the Achilles heel of any European arms policy, Article 223 has become a more malleable concept in the wider context of the EU's foreign policy: while it still shapes the discussion, it no longer stymies it. Nevertheless, the development of a common European defense industrial policy continues to be limited by the paramount desire of the member states to have final say over sensitive security issues. Over the past 15 years, however, the EU has made some inroads into the defense industrial base, and EU efforts to create a single market and integrate commercial sectors often have a greater effect on the defense industrial basis than defense issues themselves.[38] The Single European Act stands out as the most salient example of this point—defense issues are too entwined in other areas of EU authority to be left alone forever. Article 223 has come under renewed attack with each new defense proposal and will likely be amended when it comes into conflict with greater European goals.

The Single European Act and Defense Industrial Policy

The growing power of the EU over the European market was bound to confront the question of managing Europe's defense industrial base. The very size of the defense market, not to mention the ambiguous nature of dual-use products, placed defense in the path of the EU's growing power over European markets. By 1996, defense industrial output amounted to approximately 3 percent of total EU output,[39] and dual-use goods counted for approximately 38 percent of defense purchases.[40] The overlap between commercial and defense products created increasing pressure on the EU Commission to regulate this activity, notwithstanding Article 223.

The passage of the Single European Act (SEA) in 1985 created the foundation for what later became known as the "first pillar" of the European Union (i.e., the Single Market). The SEA provided the EU Commission broad authority in the commercial market, which in turn allowed the Commission to increase its limited involvement in the defense industry. Though still only touching on the fringes of defense, Article 30 of the SEA at least allowed the EU to enter into the defense question. Section 6(b) stated, "The High Contracting Parties are determined to maintain the technological and industrial conditions necessary for their security. They shall work to that end both at the national level and, where appropriate, within the framework of the competent institutions and bodies." This section was

38. Terrence Guay, in writing on the EU role in the defense industry, calls this a "spillover" effect, whereby "integration in one sector leads to technical pressures to integrate other sectors." Guay, p. 175.

39. Guay, p. 27.

40. These dual-use products have more civil applications than military. De Vestel, p. 92.

only tangential to the internal market created under the SEA and by no means amended Article 223, but it allowed the various bodies of the EU to address defense-related issued for the first time.

The SEA's greatest impact on defense industrial policy, however, was through integration of the commercial market, rather than the military market per se. First, the SEA addressed coordinated research and development, an area crucial for arms collaboration and a subject of significant overlap between commercial and military ventures.[41] Second, the SEA gave the EU Commission a role in approving company mergers, and since most defense companies also have commercial holdings, this gave the Commission some say in regulating defense mergers as well, even if states could invoke Article 223 to opt out of such approval. Finally, the SEA's measures to create an internal market, reduce trade barriers, and open public procurement all had a direct impact on defense companies that operated simultaneously in the commercial and military sectors. The measures not only forced the EU to draw more and more distinctions between commercial and defense items, but also emboldened the Commission to encroach on areas previously excluded by Article 223.[42] Thus, by vesting greater authority in the Commission over economic areas that spilled over into defense, the SEA resulted in changes notwithstanding Article 223.[43]

With the added authority provided through the SEA, the EU Commission began to focus its attention on the dual-use markets. Industry officials argued that it was arbitrary to exclude dual-use items from the common market since the majority of these items were used in commercial, not military, applications. Likewise, the Gulf War provided a powerful argument for those who claimed that national export regimes for dual-use licenses needed to be standardized, and advocated a European approach to dual-use licensing. Between 1991 and 1994 the European Union developed a dual-use export system to safeguard defense items protected under article 223, but bring about reciprocal recognition of export licenses issued by EU partners for dual-use goods.[44] The dual-use regulations, which were negotiated between the Commission and the individual countries, was adopted as a council regulation and subsequently passed by each member's national parliament.

The EU dual-use regulations, which came into effect in 1995, created common EU recognized dual-use items, a list of destination countries, and the application of controls based on common standards. Likewise, dual-use items were to trade freely within the EU, and member states were to recognize licenses issued by other EU members. Dual-use laws not only undermined the logic of isolating defense

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41. Article 130F stated that "The Community's aim shall be to strengthen the scientific and technological basis of European industry, and to encourage it to become more competitive at the international level."

42. Guay, pp. 58-59.

43. Ibid., p. 46-47.

44. EU Council Regulation 3381/94 set up a community regime for the control of exports of dual-use goods, and EU Council Decision 94/942/CFSP established joint action for the export of dual-use goods.

trade from EU policy, but also underscored a major lesson: industry pressures are ultimately the strongest driving forces for export harmonization. Industry heads in France and Germany lobbied heavily in favor of a unified EU defense export policy, citing lost contract sales due to national export licensing. Moreover, industry complaints have grown in recent years. In March 2000, for example, Turkey announced that it would not purchase the Eurocopter Tiger helicopter because of complications in the export procedure. Specifically, the German government, under pressure from the Green Party, was reluctant to sell the Tiger to Turkey, while the French government wholly supported it.[45] The complication of applying to individual states is untenable in an industry where one product may involve five or six individual export licenses.

In spite of the success the EU enjoyed in enacting dual-use laws, efforts to deal directly with arms exports have been somewhat more problematic. The Group for Cooperation in the Field of Armaments and the Harmonization of European Export Policies (COARM), established in 1991 under the Council of Ministers, focused on arms export policies to third countries. COARM eventually created the Code of Conduct, which outlined a set of eight criteria based on the destination country's characteristics (respect for human rights, risk of reexport, peace and stability, among others). But the code, adopted in 1998, is a nonbinding "gentlemen's agreement" that does not legally prohibit the signatories from exporting to any particular countries, nor does it place any quantitative or qualitative limitations on exports. In the best case, the code could be viewed as a precedent for future policy, and the EU members have incorporated at least the language of the code in their national export policies.[46] In the worst case, however, COARM demonstrates the folly of creating vacuous organizations with little or no authority. Compared with the progress achieved in defense industrial issues through the SEA, COARM has really had only a symbolic role.

The Code of Conduct highlights the weaknesses of various agencies and institutions within the EU that address defense matters. A nice idea in principle, the Code of Conduct is a hollow concept so long as it lacks legal standing—a real defense export policy cannot be voluntary. But even if a unified European export control lies outside the EU for the conceivable future, the EU continues to play a political role. Export control remains the subject of intergovernmental negotiations within the EU, and the real issue has become harmonization of export regulation. In discussions over the Code of Conduct, "France and the United Kingdom, for example, insist that it [COARM] should be discussing harmonisation measures

45. Thierry Gaualt and Franck Paul Weber, "Political Standstill," *La Tribune* (Paris) [internet version], March 9, 2000. Reported in FBIS.

46. In some cases, countries have turned the code into "threshold tests" for exports to the Third World, interpreting the code even more strictly than originally imagined. The Netherlands, for example, did in fact use the code to develop strict standards for munitions exports to particular regions and countries.

and not national policy, a view that is not shared by Germany."[47] COARM marked a significant trend regarding EU involvement in the defense industrial base; even though the SEA at first seemed to give the Commission the lead in involvement in defense industrial issues, the switch from unification to harmonization gave the Council the lead in these issues.

With the growing number of joint projects (such as the Eurofighter), and the rise of multinational defense companies (such as Matra BAE Dynamics and EADS), there will be an increasing need for a harmonized export policy. Even in cases where the EU is incapable of formulating policy, its backing of rationalization and consolidation in the European defense industry may put pressure on individual states to adopt common export policies, and eventually give legal authority to those EU institutions established to govern defense policy.[48] In dealing with such transnational companies, participating states will be forced to coordinate their policies on these issues, or risk crippling their industry's opportunities to compete in the global market. Industry continues to lobby to have agreements, such as the LOI, placed in the framework of the EU, and joint programs and European cross-ownership will create even more pressures to create consensus for a Europe-wide export control policy that goes beyond dual-use items.[49]

EU Foreign Policy and Its Impact on Defense Industrial Policy

The Common Foreign and Security Policy (CFSP), established by the Maastricht Treaty, came into force in 1993 as the second pillar of the EU.[50] Unlike the first pillar of the Single Market, CFSP was to be intergovernmental (i.e., approved and adopted in the national parliaments of all the member states rather than dealt with as community law). This limitation notwithstanding, the Amsterdam Treaty of June 1997 marked a crucial step forward for the EU's CFSP by integrating the Petersberg Tasks, previously part of the WEU, into Title V of the EU Treaty. Amsterdam therefore accelerated the slow and complicated process of transferring WEU authority over to the EU and to some extent, substituted the concept of a European force under NATO for an independent force under the EU. The Amsterdam Treaty also marked a significant watershed for the CFSP by expanding

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47. Assembly of the Western European Union, *European Armaments Restructuring and the role of the WEU*, report submitted on behalf of the Defence Committee, Document 1623, November 9, 1998.

48. In an interview, Abel Matutes, the Spanish Foreign Minister, stated quite simply, "It is clear that the common policy will force us to effect an integration of the defence industry that does not exist at present. And it will affect purchases from the USA and competition on the world market…" Interview by Alberto Ruio, "Spain's Matutes Views US Ties, ESDI, Gibraltar," *La Razon*, March 27, 2000. Reported in FBIS.

49. The Union of Industrial and Employers' Confederation of Europe (UNICE) lobbied heavily for EU involvement in dual-use export controls, and continues to support broader EU control over exports. Guay, pp. 150-151.

50. The third pillar, not discussed in this paper, but also intergovernmental, is cooperation in the field of justice and home affairs.

the Council's ability to function and define its field of activities in foreign affairs. Two of the most significant changes under Amsterdam were the designation of a secretary general of the Council as high representative for the CFSP, and the addition of a Planning and Policy Unit to the Council, providing the CFSP high representative with a mechanism to coordinate joint action.

After the CFSP was established, negotiations began over development of a crisis management force that could implement the Petersberg Tasks. Debate continued for the next several years, and a clearer picture of the force emerged at the British-French summit in Saint-Malo in December 1998. At that time, France and the UK began to agree on the principles for a military force under the EU, but outside of NATO. In Cologne in June 1999, a NATO-dependent European Security and Defense Initiative (ESDI) was finally rejected in favor of an independent rapid reaction force. The European Council Declaration in Cologne stated:

> In pursuit of our Common Foreign and Security Policy Objectives and the progressive framing of a common defence policy, we are convinced that the Council should have the ability to take decisions on the full range of conflict prevention and crisis management tasks defined in the Treaty on the European Union, the 'Petersberg Tasks.' To this end the Union must have capacity for autonomous action, backed up by credible military forces, the means to decide to use them, and a readiness to do so, in order to respond to international crises without prejudice to actions by NATO.[51]

European leaders dubbed the initiative the Common European Security and Defence Policy (later abbreviated to ESDP). ESDI, which was to be a strengthened European pillar of NATO under the WEU, became nonfunctional once it was decided that the WEU would be integrated into the EU. ESDP was different in conception: it would implement the Petersberg Tasks, but was to be both separable *and* independent of NATO forces. In the December 1999 summit in Helsinki, Finland, the EU outlined a rapid reaction force made up of a 50,000-60,000–strong army to serve in peacekeeping and crisis management missions.

Foreign Policy and the Battle for the Defense Industrial Base

When Javier Solana was appointed as the EU high commissioner for CFSP in 1999, his leadership was expected to strengthen the CFSP and to coordinate work among the member states and EU bodies. Solana's appointment, however, quickly resulted in both personal and institutional conflict with Chris Patten, the EU commissioner for external affairs. Specifically, Solana's attempt to strengthen the CFSP came at the expense of Patten's control over foreign policy under the Commission. With CFSP under control of the Council, and foreign aid policy under control of the Commission, control over the defense industrial base became a

51. Presidency Conclusions: Cologne European Council, European Council Declaration on Strengthening the Common European Policy on Security and Defence, June 3-4, 1999.

major area of competition. The stakes were, and are, by no means small—control over defense industrial policy would probably include defense research and development, defense trade and export control, procurement policy, and of course an armaments agency.

EU Commissioner Patten contends that defense industrial policy, as part of the Single Market, belongs to the Commission:

> The second reason it makes no sense to try to fence off the emerging security structures from the Commission is that defence trade and production cannot be treated as *chasse gardée* within the Single Market. Competition between defence companies. Research and development. Exports of defence equipment. Internal market aspects of defence trade, and dual-use goods, which have civil as well as military applications. All these are areas in which the benefits of the Single Market should not be denied to European Industry.[52]

This logic, however, is somewhat faulty. Even within single states, defense industrial policy is often treated separately from other economic issues, and for the defense industry to realize the "benefits of the Single Market," defense industrial policy would have to be made jointly (i.e., decided through majority voting, and Article 223 amended or abrogated). Previous attempts by the Commission to attack Article 223 failed in 1990, however, and the Commission has lost, and continues to lose, power over the direction and implementation of EU defense industrial policy. As previously discussed, the drive for export control policy, initially led by the Commission, was adopted as a Council regulation. Moreover, the Amsterdam Treaty largely subordinated the Commission to the Council by placing CFSP under the control of the latter.

Since the institutions related to foreign policy are still being molded, it is possible that a strong EU commissioner could push his/her agenda, particularly if there were little resistance from the Council. Yet, this is not the case. The Solana-Patten rivalry is not the only source of tension regarding the future direction of EU security policy. Institutional factors play a role, as well. Solana, as the head of the CFSP, has had problems similar to Patten, but Solana is also starting from a more established base. The failure of the EU member states to overcome the barriers set up in Article 223 has effectively placed all major foreign policy tools and issues, with the exception of foreign aid, in the Council. Member states' unwillingness to cede control over defense policy means that defense industrial issues will still be dealt with through intergovernmental procedures, negotiations, and thus harmonization rather than unification is more likely to result in the medium term. Likewise, the institutional power struggle over defense industrial policy between the Council and the Commission is weighted in favor of the Council. The rivalry between Solana and Patten could, however, prove to be a beneficial dynamic. As each attempts to push his respective agenda, both will in effect push defense

52. Speech by Chris Patten, "A European Foreign Policy: Ambition and Reality," given June 15, 2000, at the Institut Français des Relations Internationales (IFRI), Paris, p. 8.

industrial policy forward: Patten through the Single Market, and Solana through the Common Foreign Security Policy (CFSP).

CFSP and Procurement Policy

The most likely method that the Council will use to gain control over defense industrial policy is through procurement decisions for the rapid reaction force. That force, as now envisioned, would have 60,000 troops that would be ready for mobilization within 60 days for EU power projection of up to a year. By all accounts, this would require the European countries to acquire more strategic lift, command, control, and communications, and reconnaissance assets. Berlin and Paris argue that a unified European industry and a unified procurement policy would solve the interoperational problems (within Europe) and provide a rational and cost-effective way of equipping the new force. However, absent NATO assets, a reaction force under ESDP is more likely to resemble a police force.[53]

France and Germany's support for a central agency is not insignificant, but it is doubtful that many other countries, particularly Britain, would go along with European procurement options for the rapid reaction force. Finland enraged France in 1992, when it decided to purchase the Hornet over the Mirage, and Turkey consistently chooses U.S. equipment over European options. Norway, when forced into a corner over purchase of the Eurofighter, chose to delay the decision, and Greece chose to purchase fifty American F-16s rather than the more expensive Eurofighter. Finally, notwithstanding the Meteor decision, Britain usually chooses weapons based on costs, which often means choosing U.S.-made defense items. In either case, the majority of UK defense contracts go to UK firms, so it has little to gain and much to lose from centralized procurement.

France and Germany, the likely beneficiaries of centralized procurement, have consistently referred to the WEU's integration into the EU as an opportunity to rationalize forces through the creation of a central agency for arms procurements.[54] The German, French and Italian foreign ministries have all advocated a central European Armaments Agency that would centralize procurements for a European force, and European defense ministers have made it clear that industrial consolidation is part of the greater mission of a unified foreign policy. German defense minister Rudolf Scharping recently wrote that Europe might have to use NATO resources in the short term, but it would quickly move to provide its own resources based on European procurement through a European Armaments Agency:

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53. In fact there is a parallel proposal to have a well-equipped police force that would operate in UN-type missions. Such a police force was discussed at the EU summit meeting in June 2000. Barry James, "EU Planning Police Force for Crisis Intervention," *International Herald Tribune*, June 19, 2000, p. 1.

54. France and Germany are considered to be the beneficiaries since they are involved in most of the European-wide collaboration projects, and would benefit the most from increased purchases.

> With the creation of a common European weapons market, the objective of procuring military equipment in a more efficient manner and at lower costs is being pursued. Over the medium term, this is to lead to the foundation of a European Armaments agency. The merger of DASA, Aérospatiale Matra, and CASA in the sphere of aviation and space technology to form EADS, represents an encouraging step into the future.[55]

Germany and France have argued that this common "European weapons market," combined with a single European procurement agency, would achieve savings that would help fund the rapid reaction force.[56] It seems dubious, however, that defense industrial consolidation and centralized procurement could produce the savings necessary to overcome shortfalls in European defense spending. First, a European procurement policy that was "rational" would often end up purchasing cheaper U.S. defense items, and this is what smaller European governments often do now. Secondly, even if European defense industrial consolidation were successful in bringing down the unit price of major defense equipment, cheaper defense purchases alone would not be able to overcome the spending gap between the United States and Europe.

There are no comprehensive studies that measure how much savings can be produced through coordinated arms procurements, but given the current trends in European spending, it is doubtful that efficiency alone could sustain a European force. Except for Greece and Turkey, all of the nations involved in ESDP have flat or declining defense budgets. Several of the states, including France, Italy, and Spain, are ending conscription and transitioning to a professional army—a process that will consume resources during the interim period and limit the number of personnel available for a European force. Nor does cutting personnel achieve immediate savings: the U.S. government has learned that while it is easy to cut personnel, it is much harder to reduce costly infrastructure. Finally, the rapid reaction force envisioned under ESDP is very different from armies prepared to fight in the European theatre. A rapid reaction force needs air and sea lift, precision weapons, and advanced command, communications, and intelligence systems—systems that are all costly to procure.

Traditionally, however, the EU member states have looked at the defense base more as an economic and political issue rather than a matter of security, particularly in the post–Cold War era. Arguably, Europe would ultimately settle for a partially functional force under ESDP that falls short of military objectives, but that fulfills crucial purchase orders for the European defense base. As discussed previously, one significant problem associated with previous European collaborative projects, such as the Tornado, was that the participating countries often had differing military requirements, and the compromise solutions often decreased

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55. Rudolf Scharping, "Capable of Acting; How Europe Can Become an Equal Partner for the United States in Security Policy," *Die Zeit* (Hamburg), March 30, 2000, p. 5. Translated in FBIS.

56. Marc Deger, "Alain Richard: We are Committed to European Force's Efficiency," interview with French defense minister Alain Richard in *La Tribune* (Paris), July 18, 2000. Reported in FBIS.

interest in the purchases. If the rapid reaction force were really a "European force" rather than just contributions from individual members, then at least this barrier would be easier to overcome, and purchase orders might increase. Thus, even lacking a central armaments agency, the creation of an EU rapid reaction force might pressure more recalcitrant states, such as the UK, Greece, and Turkey, to make more European procurements.

The United States might welcome a strengthened European pillar to NATO, but it needs to recognize that ESDP, in the end, does not have to be a military success in order to achieve some of the underlying European political goals. The very process of building such a force (even if it cannot be used independently) will provide a basis for "buying European." European industry would no doubt benefit from a central procurement process needed for the force, and this would drive industrial consolidation even further, even if it yielded a less-than-independent force. Solana already refuses to call ESDP an "army," and even if ESDP is dependent on NATO, its procurement policies could strengthen the European industrial base.

Internal Dissent and the Rapid Reaction Force

For a rapid reaction force under ESDP to succeed, the EU must resolve two major problems: the relationship between ESDP and NATO, and the membership status of individual countries (EU and non-EU) in the rapid reaction force. The relationship with NATO will be formative in deciding what systems and platforms the force will require, and member status will determine what contributions individual states will make.

The appointment of Javier Solana, former NATO secretary general, to EU high commissioner for external affairs, produced high hopes that permanent relations would be established between the EU and NATO. Thus far, at least, this does not seem to be the case. Solana has already suffered at least one major defeat since taking up his new post. Solana's request for DM4.6 million to have a separate Brussels building for security policy was turned down by the Council of Ministers. In a February 2000 meeting of EU foreign ministers, the EU's Portuguese presidency forwarded a plan to establish permanent contacts with NATO. The proposal included an EU office stationed in NATO's SHAPE headquarters, and a NATO office located in the Council building. Another proposal was to have NATO Secretary General George Robertson attend EU summits, and the EU high commissioner would take part in similar NATO meetings.[57] None of these plans led to concrete results, and EU-NATO contacts remained limited to bimonthly breakfast meetings between Solana and Robertson.

In part, these failures have been the result of French intransigence. France views improved political relations with NATO as a pretext for greater U.S. political control over European defense policy. Solana's problems, however, have resulted

57. Ask Rostrup, "Danish EU Officer in Civilian Job," *Berligske Tidende* (Copenhagen) [internet version], February 14, 2000. Reported in FBIS.

not merely from his dealings with the larger countries such as France and Germany, but also from the curious way that EU institutions balance the interests of small and large countries. As secretary general of NATO, Solana was mindful of the United States' dominating role. Conversely, within the EU, deference toward France and Germany can backfire with smaller countries that want to maintain their global role and resent being slighted.

While France and Germany have forged ahead with ESDP plans, Britain has remained cautious, and does not want to be seen as either undermining its special relationship with the United States, or harming relations with NATO. The British stance, which is to keep the CFSP out of majority decisionmaking, continues to nettle both the Germans and French. Even Britain, which under Tony Blair's leadership has been more supportive of integration efforts, is unlikely to support a totally independent ESDP. Nor is Britain the only country concerned with the direction of ESDP. Smaller countries, such as Denmark, must first resolve internal political struggles over the concept of military cooperation. For the time being, Denmark, under pressure from its Left, has decided that it will refrain from taking part in the military structure of the EU, and will send a civilian to represent its interests in the interim military committee.

The status of non-EU NATO members poses another dilemma. Norway, a NATO member and WEU associate, but not a member of the EU, has expressed its reservations over the accelerated integration of defense structures within the EU. In a recent statement on WEU integration, Norwegian defense minister Eldbjorg Lower said, "…there is an important constitutional question in this context (i.e., whether Norway can contribute forces to an EU-led operation without having full access to and participation in planning for that operation)."[58]

Likewise, Turkey, a NATO member and EU candidate, has expressed repeated reservations over the development of ESDP, fearing that the lack of institutional relations between the EU and NATO will lead to more problems.[59] With Turkey's EU membership remaining uncertain because of concerns over Turkey's human rights policies, Turkey fears being left out of the decisionmaking structure of a future EU-led force. This is particularly disconcerting for the Turkish government, since at least in military alliances, such as NATO, Turkey is seen as a key strategic partner. The United States has also expressed concerns that those countries not yet in the EU but seeking full membership (such as Poland, the Czech Republic, and Hungary) will come under pressure to join the military structures of the EU without regard for their NATO obligations.

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58. Quoted in *Aftenposten* (Oslo) [internet version], January 10, 2000. Reported in FBIS.

59. Turkey's permanent representative to NATO, Onur Oymen said: "The most important among the resolutions taken at the end of the Washington Summit is probably the one that foresees the building of a common structure between NATO and the Western European Union upon existing grounds. However, the European Union has not yet reached a position where it can display full compliance with the Washington Resolutions." Quoted in "Turkey's NATO Envoy Says ESDI Developments Unsatisfactory," *Anatolia* (Ankara), May 23, 2000.

There is the status of nonaligned countries to consider as well. The non-NATO members of the EU—Finland, Sweden, and Ireland—have all expressed reservations about the way the larger countries have dealt with military structures and plans. In the March 2000 meeting of EU foreign ministers in Brussels, the Finnish foreign minister complained that the ministers from larger countries presented military plans to the smaller countries without even providing them the opportunity to discuss the issues.[60] The fear that smaller countries have of being overshadowed by larger countries, particularly by France and Germany, will continue to be a stumbling block to WEU integration into EU structures.[61]

Conclusions

For Javier Solana to build an effective rapid reaction force under the ESDP, he must obtain the support of smaller states and resolve longstanding conflicts between London and Paris over the relationship of ESDP to NATO. Regardless of the outcome of this relationship, the EU must decide what resources and systems it needs to obtain on its own. An independent ESDP, in particular, requires even more careful accounting to decide what sort of force Europe can afford and under what circumstances it will be deployed. So far, all talk of a crisis force has been theoretical, and the closest the Europeans have come to an actual contingency was in a computer simulation on the imaginary island of Kiloland (presumably another East Timor). The only thing to emerge from the computer scenario was confirmation that decisionmaking authority over NATO resources is indeed a source of conflict.[62]

Europe does not have the resources it needs to field a truly independent crisis intervention force, nor does it seem prepared to commit the funds needed to make progress in this regard. No amount of rationalized procurement, joint development or political desire will solve the basic lack of equipment seen in Kosovo. Thus, French objections notwithstanding, ESDP will probably work out WEU-like arrangements with NATO under which the rapid reaction force would use NATO resources and be subject to the NATO command structure. Not only are such arrangements necessary to gain support from several participating countries, including Britain, but simple economics dictates such a resolution. ESDP does have the potential to achieve advances in other areas, particularly in procurement policy. Britain, no doubt, would probably be willing to make more concessions to European procurements, as it has in the past, in exchange for working out a

60. According to Finnish foreign minister Erkki Toumioja, non-NATO countries weren't even presented with military documents until the evening before the meeting. "Finland: Big EU Powers Setting Pace for ESDI," *Helsingin Sanomat*, March 21, 2000. Reported in FBIS.

61. According to Constanze Stelzenmueller, commenting for the German publication, *Die Zeit*, "Solana's plan for himself to take over permanent chairmanship of the most important committee of the new EU defense policy, instead of the six-month rotating EU Council presidency, failed due to the resistance of the small countries." "Bizarre Conflict," *Die Zeit* (Hamburg), March 2, 2000, p. 5. Reported in FBIS.

62. The only thing scenarios can do at this stage is test decisionmaking, not forces. Constanze Stezensmueller, "Bizarre Conflict," *Die Zeit* (Hamburg), March 2, 2000. Reported in FBIS.

reasonable relationship between ESDP and NATO, for which it has lobbied consistently from the start. Since the forces under ESDP will not likely be a credible force outside of NATO, it may be that what France and Germany are really striving for are concessions from EU states that benefit the European industrial base.

Transatlantic Cooperation: Staving off a Fortress Mentality?

European consolidation has acted as a wake-up call for U.S. policymakers who were preoccupied with their own financially plagued industrial base. The nature of the defense market has changed drastically over the past ten years, affecting the way both Europe and the United States do business. While the United States consolidated its defense industry more rapidly than the Europeans, it was also hurt by drastic cuts in the defense budget. The defense industry turned increasingly to export markets, running up against an export policy that was still oriented toward controlling the flow of weapons to the now defunct Soviet Union. Some U.S. industry estimates place losses caused by export licensing delays in the billions.[63] These losses have implications that go beyond the defense industrial base as well, since defense trade, after all, is still the one of the few bright spots in the U.S. trade deficit.

At the same time, European companies moved forward very quickly, making strides in consolidating both the commercial and defense fields. From the U.S. standpoint, stronger European competition in third markets, combined with possible exclusion of U.S. companies from the European defense market, poses a substantial threat to the U.S. industrial base.

U.S. Policy and Transatlantic Cooperation

From a European perspective on U.S. policy, market access and export control restrictions are the two largest barriers to armaments cooperation.[64] Market access continues to be tied to the long-standing debate over the one-way flow of arms—European officials assert that even in those cases where European are competitive with U.S. companies, the DoD chooses U.S. equipment under the Buy American Act. The Buy American Act, however, is less of an issue than it once was, since many European nations have been granted case-by-case waivers based on reciprocal agreements. In any case, all states tend to favor domestic procurements when

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63. According to John Douglass, president of the Aerospace Industries Association, "This problem [export control] could cost U.S. companies tens of billions a year if it isn't fixed." Quoted in Anne Marie Squeo, "Regulations Stifle U.S. Aerospace Sales: Once-Profitable Exports Wane, as do New Contracts," *Wall Street Journal*, March 16, 2000, p. A2.

64. Some would argue that the Committee on Foreign Investment in the United States (CFIUS) also is a barrier. Under the Exon-Florio Amendment of 1998, CFIUS monitors and if necessary, limits, foreign ownership and investment in defense-related industries. However, in practice, CFIUS has only made one recommendation that has resulted in a blocked transaction. More importantly, European industry leaders do not generally see CFIUS as a major barrier.

available, and regardless of the Buy America Act, such practices are bound to continue.

The U.S. export policy for defense items, however, remains the largest obstacle to transatlantic defense cooperation, and this issue has far overshadowed the Buy America Act in discussions between the U.S. and European governments. Senior U.S. and European officials and industry leaders alike have complained that the U.S. State Department controls too many items, takes too long to process licenses, and denies and overly restricts licenses in a manner that harms industry's ability to sell munitions to legitimate customers. The effect of these restrictions on cooperation is best seen through the relationship between Canadian and U.S. defense firms. Canada enjoyed broad exemptions under the International Traffic in Arms Regulations (ITAR) until April 1999, when the United States lifted the exemption after allegations of a pending Canadian deal with Iran. Although the exemption was restored six months later, the interim restrictions proved expensive for both sides. Canadian subsidiaries of U.S. firms suddenly had to obtain licenses to share technical information that had once been routinely exchanged, and spare parts were held up for over three months awaiting State Department approval. Though such delays may be routine for business with Europe, Canada and the United States have extensive ties in the defense sector, a direct result of the now reinstated ITAR exemption.[65]

The export question is not just a matter of obstacles created by the State Department bureaucracy, but ultimately, of political control over exports. This factor was most evident in the British competition to arm the Eurofighter, one of the largest missile contracts of the last ten years. The choice was between Raytheon's already-developed Advanced Medium Range Air to Air Missile (AMRAAM) and the as-yet-undeveloped Beyond Visual Range Air to Air Missile (BVRAAM), proposed by Matra BAE Dynamics. One of the major reasons that Britain chose the BVRAAM to arm the Eurofighter was that if the UK had procured Raytheon's AMRAAM, then Matra BAE Dynamics would lack the funds to develop the European BVRAAM. This would have likely meant that all future Eurofighters would be armed with U.S.-made AMRAAM. DASA chief executive Manfred Bischoff put the choice simply, "In opting for an America solution, London would give the United States a chance to veto future sales of Eurofighter and this could favour sales of their own combat aircraft."[66] If the Eurofighter were armed with the AMRAAM, then each time that Europe would want to export the Eurofighter, it would have to seek U.S. approval for export of the AMRAAM. If the U.S. disallowed export of the AMRAAM, this would be a *de facto* veto of the Eurofighter, since a fighter without missiles is functionally useless. This, of course, was not the only or even the most important reason in the procurement decision, but it was significant.

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65. Colin Clark, "US, Canada Agree on Cross-border Defense Arms Trade," *Defense News*, May 5, 2000, p. 4.

66. Quoted in "DASA's Bischoff Urges UK to Opt for Meteor," Reuters, February 10, 2000. Online at <http://biz.yahoo.com>.

European perceptions of U.S. export restrictions are as difficult to overcome as the barriers themselves. In a report to the North Atlantic Assembly, one observer repeated a frequent criticism that the State Department was using export control as a way to further U.S. commercial interests. He cited as an example a denial the State Department issued to Germany for a modified AIM9L air-to-air missile that was to be sold to Sweden. After denying the license, he alleged the United States sold a similar missile to Sweden.[67] Though the State Department would no doubt dispute the details of the account, European perception is clearly one of mistrust. For European industry, which uses a large volume of U.S. parts and components in its systems, U.S. delays are deemed an unwarranted and costly burden that prevents any meaningful industrial cooperation.

The growing acrimony between the United States and Europe has begun to have repercussions for U.S. industry. In 1999, a DASA memo directing managers to find non-U.S. suppliers for military parts and components was leaked to the press.[68] Frustrated with extended export license delays, DASA began to look for alternative, mainly French, suppliers for engine parts. DASA later denied that the goal was to cut off supplier relationships with U.S. companies, but simply to have alternative sources. The fact remains that as the costs of doing business with U.S. companies grow, there may be no other choice for European defense companies but to look for European solutions. The impact on U.S. defense companies would no doubt be severe, and without European exports, the unit costs for production would rise, resulting in even more problems for U.S. competitiveness in the world market as well as greater costs to the U.S. defense budget.

European complaints over both policy and implementation of U.S. export control are pandemic and increasingly acrimonious. The issue is not just over major armaments, such as missiles, but over the right of European countries to export systems that use U.S. components. From the standpoint of European officials and industry, it is ridiculous that European countries should have to ask permission to export their own product, simply because a small component was provided by a U.S. firm. Even in the best case, the system smacks of arrogance since it assumes that European export controls are inferior to those of the United States. In the worst case, it is viewed as a U.S. ambition to control exports for its own political or economic gain.

The DoD has also become a strong supporter of changes to the export control regime, and several top DoD officials have spoken out heavily in favor of reforms to help promote transatlantic cooperation. Jacques Gansler, undersecretary of defense for acquisition and technology, has spoken repeatedly about the need to "release advanced technology" to European allies and "modernize and speed up the export control process" in order to enhance transatlantic linkages.[69] At issue is the

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67. Norbert Wieczorek, *Transatlantic Defence Trade and Changing Defence Markets,* draft general report to the Committees of the North Atlantic Assembly, April 16, 1997, p. 6. Online at <http://www.vm.ee/nato/related/naa/docu/1997/ap97ec.htm>.

68. Tony Cappaccio, "DaimlerChrysler Aerospace Bars U.S. Made Components," *Defense Week* [internet version], November 1, 1999.

69. Speech at the International Aerospace and Air Transport Conference, June 20, 2000.

ability of U.S. companies to trade defense articles and technical data with U.S. allies without the added burden of multiple licenses. Partnerships, let alone mergers, are impossible in an environment where even the exchange of technical data with a European firm could require a three-month wait. Export control for munitions, however, remains firmly entrenched in the State Department, which tends to be more skeptical of economic arguments for reform.

In May 2000, however, after long negotiations, the DoD and State Department announced the U.S. Defense Trade Security Initiative (DTSI), which included major adjustments to the U.S. defense export control system under International Traffic in Arms Regulations (ITAR). The initiative addressed long-sought regulatory and bureaucratic reforms, but the underlying theme was the need to foster transatlantic cooperation. The 17 specific reforms outlined under DTSI expanded existing programs and created new measures that could potentially increase transatlantic partnerships. The list included measures such as major program licensing, major project licensing, global project licensing, and arrangements for the exchange of technical data for acquisitions, teaming, mergers, and joint ventures—all measures designed to alleviate grievances of bureaucratic delay. Most significant, perhaps, was a proposed "Canadian-like" exemption status for Australia and the UK that would allow for license-free trade in some areas. As a package, the reforms signify a substantive change in U.S. policy, but as some European commentators pointed out, the benefits were more for U.S. business.

There are several major problems with the DTSI. First, it will not be lost on the Europeans that the reforms are intended to make it easier for the Europeans to buy U.S. defense items. The reforms included a list of "priority items" that fall under the Defense Capability Initiative (DCI) and would thus receive expedited processing. Since most of the equipment under DCI is of U.S. origin, this is not seen by the Europeans as a benefit to their industrial base. On the other hand, the broad exemptions proposed for the UK and Australia could have far-reaching and more immediate consequences if approved. The reforms leave open the possibility of extending the broad ITAR exemptions to countries that meet five so-called pillars of compatibility and confidence (i.e., reciprocal export control and industrial security regimes, cooperative relationships in intelligence sharing and law enforcement, and guaranteed reciprocal access to defense markets).

Though this might open up the possibility of similar exemptions being extended to more European countries, it also gives rise to new problems in transatlantic relations. Since an exemption is granted to those countries based, in large part, on their export control regime, it creates a system of classification by deeming some governments' export control systems as acceptable to the United States, and others as not. Officials of several European countries have already pointed out that it is inappropriate to rank (order) allies, or to assume that some NATO countries are more trustworthy than others. Similarly, non-NATO European countries have objected to DTSI measures that effectively discriminate against them, and in

effect provide trade advantages based on a military alliance.[70] The latest round of export control reform does not go far enough in the eyes of European officials and industry leaders and could even damage transatlantic relations.

Finally, German and French officials have expressed contempt for the repeated U.S. insistence on bilateral negotiations with European countries to obtain ITAR exemptions. Given the continued negotiations for harmonized export regulations under the LOI, some European officials felt "betrayed" that the United Kingdom, in particular, had already agreed on a Declaration of Principles with the United States, rather than holding out for a multilateral agreement between the United States and the LOI states. Several LOI states believed that if the six participating members could first negotiate harmonized export regulations amongst themselves, then they could negotiate directly with the United States as unified partners, rather than as individual states. In some German officials' view, the blame is shared by the United States, which continually refuses to acknowledge the growing links among European states, and the United Kingdom, which chose to slight European unity in favor of its own national and economic interests.

Transatlantic Cooperation or Transatlantic Mergers?

Many industry analysts have begun to repeat the mantra of transatlantic mergers as a sensible way for U.S. defense firms to increase market share in Europe and rationalize defense production.[71] BAE Systems is often cited as the best possibility for a transatlantic merger. Shortly after Finmeccanica announced that Alenia would join EADS and not BAE Systems, rumors circulated of an impending Boeing/BAE Systems merger.[72] There seemed at first glance to be some credibility to this rumor: an Anglo-American alliance in industry is already a fact, given the close working relationship between BAE Systems and Boeing. BAE Systems' merger with GEC's electronics division, Marconi Electronics Systems, provided it with an attractive position in the U.S. market—GEC had recently acquired Tracor's defense electronics holdings, in addition to other U.S. business units. These holdings make BAE Systems an attractive partner for Boeing, and the two companies already have extensive supply contracts and teaming agreements. But BAE Systems' link to Boeing is not exclusive; it also maintains strong links with Lockheed Martin through the Joint Strike Fighter, among other joint projects. As an executive from Aérospatiale Matra put it, "BAE wants to keep its thumb in both pies."[73] Moreover, the rumor of an impending merger, which came right after BAE

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70. In particular, they object to ITAR provisions that allow for the license-free transfer of some defense items to NATO governments, while the transfer to non-NATO European states still requires a license. Interviews, Washington, D.C., August 2000.

71. Such industry support goes back over five years. In 1994, Booze Allen & Hamilton put out a report by John Harbison and Martin Bollinger, entitled "The Case for Transatlantic Mergers," which claimed prime mergers were the logical direction of defense consolidation.

72. Reports of a merger, which first appeared in the Sunday *Telegraph*, were neither confirmed nor denied by either party. Ivar Simensen, "BAe, Boeing said in talks on $47 billion merger," *CBS MarketWatch On-line*, April 9, 2000.

73. Interview, Washington, D.C., April 2000.

Systems' unsuccessful bid for Alenia Aerospace, was probably a strategically leaked exaggeration. Apart from anger over being snubbed, BAE Systems managers were incensed over EADS' proposal to "sweeten the pot" by promising Finmeccanica a 5-percent stake in Airbus. Control over Airbus has long been a contentious topic among its partners, and the threat of an Anglo-American merger was probably meant to send a clear message to EADS.[74]

It is unlikely that a merger between BAE Systems and Boeing would actually take place over the next several years. BAE Systems' 20 percent stake in Airbus would represent a conflict of interest with any Boeing merger, and it is unlikely that BAE Systems would want to divest itself of such a profitable holding. BAE Systems' purchase of Lockheed Martin's Aerospace Electronics Systems (AES) business, announced in July 2000, marked a further extension of BAE Systems into the U.S. market,[75] but these acquisitions do not alter the basic "Europeaness" of BAE Systems business operations. BAE Systems may move closer to the United States, but it is still deeply entrenched in Europe through cross-ownership. Along with Airbus, BAE Systems also has a stake in the missile sector, through Matra BAE Dynamics, in the very profitable space sector through Astrium, and in land and sea systems through Alenia Marconi Systems. Additionally, BAE Systems has board membership and cross-ownership in SAAB, and the two companies collaborate on the Gripen fighter. Finally, the British government's commitment to remain involved in European collaboration projects will also keep BAE Systems firmly rooted in Europe. Even if the UK is not a "part of Europe," then neither is it about to become the "fifty-first state" of the defense sector.

In other words, BAE Systems may be content to stay the course. Richard Evans, the UK defence and aerospace group's chairman, categorically ruled out such mergers at present: "Even if we [BAE and Boeing] wanted to marry one another—and this isn't the case—it would be completely impossible. How on earth would we do it."[76] Given that this is the feeling of the European company with the closest ties to both U.S. government and defense companies, it seems even more doubtful that either side is ready for mergers at the prime level.

Even if such a transatlantic merger at the prime level were to take place, it might not have the desired economic effects. Transatlantic mergers in the commercial sector, as in the case of DaimlerChrysler, do not necessarily drive stock

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74. The merger rumor was leaked to the London *Telegraph,* and Boeing and BAE officials refused to confirm or deny the rumors for several days. Although it is impossible to know whether the rumor was "leaked misinformation," it does make sense. BAE has said repeatedly it would not allow Airbus ownership to be used as a lure for Alenia, and EADS officials are well aware that ownership in Airbus is a major factor preventing BAE from merging with Boeing (though there are other factors).

75. The U.S.$1.67-billion purchase should place BAE Systems in the number two defense contractor position, the place occupied by Lockheed Martin. "BAE Systems Buys Lockheed Martin's Aerospace Electronics Systems," *Defence Systems Daily,* July 14, 2000. Online at <http://defence-data.com >.

76. Quoted in Alexander Nicoll, "BAE Rules Out Mergers," *Financial Times* [internet version], July 30, 2000.

prices up or improve overall performance. The German-American union faced management disputes that ended in board restructuring, which led some analysts to conclude that the German side dominates business decisions. Additionally, profits are down and share prices have also sunk.[77] Although there is no example of an equivalent transatlantic merger in defense, large transnational mergers, such as EADS, have yet to prove their viability. EADS debuted with less than fortuitous results: on July 10, 2000, EADS stock appeared simultaneously on three stock exchanges but ended up selling for about 20 percent less than Aérospatiale Matra's stock had sold for prior to the merger.[78] It seems that investors had lingering questions over EADS, including the convoluted transnational management structure, concerns over French government control, and doubts about the cost savings that could be achieved through integration.[79] These same problems would also be faced in a transatlantic merger at the prime level, and there is no reason to believe that these problems would be any easier to overcome.

Defense markets are complicated by the nature of the business: defense companies cannot take advantage of business opportunities with the same flexibility as purely commercial ventures—product development depends on government commitment, rather than commercial demand, and even after development, companies are limited in where they can market their products. A transatlantic merger of prime defense contractors would also face internal barriers, including disputes over labor policy, management structure, board membership and government ownership, not to mention government approval for the merger itself. Even if a merger were approved by the respective governments, it would most certainly be done with provisos that mandate supply guarantees and limit the ability of the company to close down some production lines and factories within the constituent countries. In these cases, it would be even more difficult for the company to realize efficiencies. Defense mergers are extremely hard to handle even in a single country, as the debt-ridden Lockheed Martin demonstrates.[80] Mergers of prime contractors is a tricky business since integrating overlapping business units can be much harder to manage than acquiring new units, which has been the trend in current transatlantic acquisitions. Mergers assume that rationalization will take place and produce efficiencies, but this is difficult in one country, and over several countries, or a continent, the task could be insurmountable.

Nonetheless, the complex interaction of industry and government is unpredictable, and much depends on decisions made by government officials and

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77. "EADS: Testing Time for a New Corporate Model," *Jane's Defense Industry*, June 30, 2000. Online at <http://www.janes.com>.

78. Aérospatiale Matra had sold for between 21 and 24 ECU before the merger, compared to the ECU 17 of EADS. "EADS Initial Public Offering: Now Comes the Difficult Part," *Defence Systems Daily*, August 2000. Online at <http://defence-data.com>.

79. EADS stock rebounded slightly in October 2000, after Singapore Airlines pledged to purchase 25 A3XX superjumbos from Airbus. The rebound, however, was less than 5 percent and still failed to meet the initial expectations for EADS' stock price.

80. Similarly, the integration of Aérospatiale and Matra business units, now under EADS, is still incomplete.

business executives. As a recent summary of the flurry of consolidation in the *Financial Times* noted:

> Two years ago, the present shape of the European defence industry could not have been forecast. At that time, British Aerospace was negotiating a merger with Daimler-Benz Aerospace (DASA) that was intended to herald the coming-together of all four Airbus partners. General Electric Company of the UK had set out a strategy to make defence a core business. The French government's shift of policy to allow the privatization of Aérospatiale came as recently as July 22, 1998.[81]

To say that transatlantic mergers at the prime level is unlikely is not to say they are impossible, and the United States should be prepared to deal with such a scenario. Market conditions change rapidly, and industry is always faster to adapt than government. Rather, what this paper has argued is simply that the conditions are not yet ripe—there are too many issues to resolve with sub-prime mergers, collaborative projects and export regulations. And while developments in the European market cannot be predicted, it is clear from current European attitudes that without substantial changes in U.S. policy, U.S. defense companies will be left out of many lucrative European projects. Europe does not have to shut its doors in any regulatory context in order to hurt U.S. companies. Rather, what is likely to take place is a slow weaning of European companies away from U.S. suppliers and growing competition between U.S. and European companies in third markets. For U.S. companies that depend on exports to keep production lines open, such a scenario, though less daunting than a fortress, would still have a significant negative impact.

The Endgame: Pan-European Companies and the Future of Transatlantic Cooperation

If the decision to unite three of the largest European defense industries under the auspices of EADS was the major event of 1999, then the new millennium has already seen three developments equally critical for the future of Europe's defense industrial base. The first was Tony Blair's decision to purchase the as-yet-undeveloped BVRAAM to arm the Eurofighter—a decision taken after extensive U.S. lobbying to choose the cheaper Raytheon-led AMRAAM option. The second, also after much lobbying, was Finmeccanica's decision to allow its subsidiary, Alenia Aerospace to join EADS in a join venture in aircraft. Finally, and no less significant, was the long-awaited completion of the Airbus negotiations and the incorporation of Airbus Industrie as the Airbus Integrated Company (AIC) in late June 2000. Nor is consolidation completely over, as there is still some room to merge and plenty of overlap. In the electronics sector, Thomson-CSF, now joined with Racal, still has a significant market share. There is also room for consolida-

81. Alexander Nicoll, "All change with the names and shapes," *Financial Times*, July 24, 2000, p. II.

tion in the missile sector, and Matra BAE Dynamics management has stated that it wants to create a pan-European missile venture.[82] Likewise, Dassault and SAAB are still active in the aircraft sector, leaving some room for consolidation.[83] The decisions these companies take will still influence the European defense market, and for the time being, make talk of a "Fortress Europe" a bit premature.

EADS and the Future of European Industry

The disappointing results of EADS' initial public offering came in spite of the company's recent triumph with the establishment of a 50–50 joint venture with Alenia Aerospace in military aircraft. The Alenia decision had been widely expected, and Finmeccanica had many reasons to choose EADS over BAE Systems for its subsidiary, but the reasoning behind the deal, as one commentator put it, was "Euro-fluffiness."[84] During the competition, the Italian government came under heavy pressure to make the choice "for Europe," perhaps as a way to make up for its poor resource allocation for European defense. Well before the competition was in full swing, an Italian newspaper called for Italy to join EADS declaring, "There is thus no alternative to the industrial 'holy alliance,' and anyone who opposes this and tries to hold out in splendid isolation simply risks bankruptcy."[85]

The 50–50 joint venture is not institutionally conducive to restructuring, however, since it effectively allows each partner to maintain its own factories and workforce. More than a few commentators have noted that both governments are jealously guarding their factories, and neither side is willing to close production lines.[86] If that remains the case, then EADS may indeed be heading for problems already foreshadowed by the disappointing stock performance since it went public in July. One Aérospatiale Matra executive said that both DASA and Aérospatiale Matra have already made all the workforce reductions they intend to make and do not anticipate any more cuts. Moreover, he noted, "It is more in line with the European policy to maintain a level work force [in the defense industry] even when there is a lag in production. This guarantees that when production picks up, there are skilled workers available."[87]

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82. "EADS/Elenia Tie-Up….Best of Spouses?" *Defence Systems Daily*, May 9, 2000. Online at <http://defence-data.com>.

83. Schmitt, p. 55.

84. Most analysts expected the EADS-Alenia lineup and acknowledged it was probably the better match. However, the criticism was aimed at whether EADS really has the will to rationalize its operations by streamlining R&D and eliminating other redundant areas. "EADS/Alenia Tie-Up…Best of Spouses?" *Defence Systems Daily*, May 9, 2000. Online at <http://defence-data.com>.

85. Andrea Nativi, "Spend More, or Resign Ourselves to Counting For Less," *Rome Times* (in Italian), October 20, 1999, pp. 99-106. Reported in FBIS.

86. One of the biggest areas of overlap is final assembly, a capacity that each country has and none wants to give up. Likewise, no one wants to give up their test centers. Erwin Obermeier, DASA's head of military aircraft, even advocated using each country for a different type of flight test. Stewart Penney, "Alenia Decision to Join EADS Could Help Eurofighter Export Production," *Flight International*, July 11, 2000, p. 15.

87. Interview in Washington, D.C., April 2000.

There is yet another troubling concern that EADS will be forced to contend with once the flurry of mergers settles down. Even if EADS is able to overcome some of the built-in barriers to workforce reductions and factory consolidation, it remains to be seen whether even a consolidated company can survive further contractions of European defense budgets. European states continue to cut their defense budgets, and this trend is not likely to change over the next several years.[88] Even more troubling is the paltry sum spent in Europe on research and development. While combined European defense budgets could in theory procure at a rate not far behind the United States, the lack of research and development would ultimately leave European companies lagging behind. In 1999, for example, the United States spent approximately $47 billion on defense equipment, compared to Europe's $32 billion. However, in research and development, the United States spent over $35 billion, compared to Europe's $9 billion (figures 2 and 3).[89]

Though EADS management would of course like to profit from a European preference in defense spending, the solution is not a "Fortress Europe." EADS must make inroads into the U.S. defense market in order to obtain crucial access to both procurement and R&D money. EADS officials acknowledge that the best way to obtain U.S. contracts is through teaming agreements with U.S. companies.[90] EADS has already signed two new MOU's with Lockheed Martin, including one for a High Altitude Long Endurance Unmanned Aerial Vehicle (HALE UAV) and another for support systems and process development for the Joint Strike Fighter. EADS management has consistently stressed that its strategy is to expand partnerships in the United States, and it will take several years to see whether this strategy pays off. The receptiveness of the U.S. government to such partnerships will probably be the crucial test.

The Role of the United Kingdom in the European Defense Base

The most pressing question for U.S. policymakers is whether U.S. companies are being closed out of the European market. A glance at some of the last few major competitions does reflect a trend toward a European preference in procurements. Germany's decision in June 2000 to purchase Rolls Royce engines over General Electric Aircraft engines for the NH-90 helicopter led some to renew accusations of a "Fortress Europe."[91] The NH-90 decision, together with Britain's controversial BVRAAM procurement, lends a certain amount of credence to those who believe that Europe is closing ranks. Nevertheless, from a European perspective, the UK is not widely regarded as an integral part of a future integrated industrial base. As

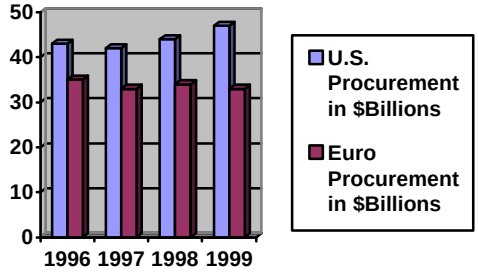
88. Turkey, an EU candidate, has a slightly increasing defense budget. Merrill Lynch, "Investment Implications of the Airbus A3XX," *Pilot*, No. 10, June 28, 2000, p. 34.

89. Ibid., p. 10.

90. EADS is skeptical that the Pentagon would award the company many direct contracts. However, the U.S. Navy did award EADS an $11.9-million contract in September 2000 for delivery of electronics for the AN/APG-65 radar system for the Hornet.

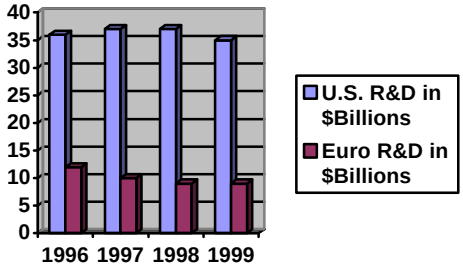
91. Colin Clark, "Losers Complain Politics Steered Germany's Engine Choice for NH-90," *Defense News* [internet version], June 19, 2000.

Figure 2. Comparative Procurements, 1996-1999



Source: Merrill Lynch

Figure 3. Comparative R&D, 1996-1999



Source: Merrill Lynch

one European industry official noted, "The UK is not Europe—it is in between Europe and the United States. Nobody in Europe considers the UK as European."[92] Without the UK, there can be no "Fortress Europe" since the UK makes up almost 40 percent of total European procurement: in 1998 it spent approximately $14 billion on defense procurement; Germany by comparison spent only $6 billion.[93] As most European officials concede, the European defense market cannot survive without some U.S. market share, so a "Fortress Europe" that excluded both the United States and UK would be even less likely.

Even though the UK has participated in many joint European programs, often under political pressure, it has followed an independent procurement policy that

92. Interview in The Hague, Netherlands, July 2000. Whereas the first part of the remark is geographically correct, the second part is especially overstated in the context of Tony Blair's interest in asserting a central role for his country in Europe.

93. *Pilot*, p. 34.

heavily favors cheaper (i.e. U.S.) equipment. When the UK has gone along with ill-advised European programs, it has usually been as some sort of political or economic trade-off. In the case of the BVRAAM, the UK decision seems to underscore the point that believing in a European identity may be just as important in the endgame as actually having one. Awarding the nearly $1-billion contract to the Anglo-French joint venture in missiles seemed to be the logical conclusion to the direction the European industry was going. Tony Blair was able to prove himself "a good European" even as the UK remains the black sheep of the EU family for its refusal to join the European Monetary Union.[94] This decision, in fact, is extremely reminiscent of the debate over the Tornado aircraft. Almost 30 years earlier, the UK agreed to join the Tornado project in part to gain support from France and Germany for its membership to the European Economic Community.[95] Defense programs remain a political tool, and even in the absence of formal structures that would dictate the procurement choices, decisions will increasingly be made in the context of European and EU politics. As the Meteor decision reaffirmed, the defense industry for Europe will always be first and foremost a compromise between politics and economics, and only secondarily a matter of national security.

Finally, the position of BAE Systems also plays a moderating influence in a "Fortress Europe" scenario: the company plays a careful balancing act between European and Anglo-American alliances. BAE Systems would not join EADS, as some have suggested, and risk cutting itself off from the U.S. market, which accounts for a significant part of its revenue. Unlike EADS, which has little to lose in the U.S. market, BAE Systems has a special status and is the third-largest supplier for DoD contracts. Likewise, as previously discussed, BAE Systems is not likely to pursue a merger with a U.S. company.

The Airbus Model and Implications for the Defense Sector

Turning from the defense to the civilian sector, Airbus has emerged as a powerful economic competitor to the U.S.-based Boeing company. Airbus now outstrips Boeing in new aircraft orders, though it still fails to outperform Boeing in actual deliveries. Boeing severely underestimated the market for a jumbo airliner, while Airbus Industrie has already received orders for its as-yet-undeveloped A3XX superjumbo. The coordination of European government support for the A3XX hints at the role a united Europe may play in both defense and civilian markets. What emerges from this picture is a successful example of European-guided industry programs that will no doubt spill over into the defense sector, since Airbus will develop the Future Large Transport Aircraft.

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94. Nonetheless, the UK government is protecting itself against delays that have plagued the Eurofighter (once called Eurofighter 2000). The government has said that if Matra BAE Dynamics does not meet certain deadlines for development, the contract will be terminated and development costs will be returned. "Britain Bolsters Europe's Defence," *Financial Times* [internet version], May 18, 2000.

95. Edgar, p. 51.

The Airbus A3XX large aircraft project has met with unexpected success by following a strategy employed with its previous lines: rather than copy an existing Boeing model, it sought to develop a substantially different aircraft to meet the projected needs of commercial airlines. The $12-billion project has already received interest and the promise of future procurement, surprising Boeing management, which did not think there was much market potential in developing a new jumbo jet. Boeing, on the other hand, decided to overhaul its older models into jumbo jets, repeating a strategy that had failed when it competed against the Airbus A320. Airbus has managed to outstrip Boeing's sales by concentrating on building newer models, rather than updating older ones, and then successfully marketing its new models to the growing commercial aerospace sector.

As opposed to some ill-fated collaborative military projects, Airbus has succeeded by virtue of its commercial nature—contracts are awarded on a competitive basis according to national specialization, and not according to quotas based on national contribution. Nor are contracts awarded based on ownership. Even though EADS holds 80 percent of the company, and BAE systems the remaining 20 percent, the bidding process for contracts is competitive, even if influenced by political factors. This arrangement created a situation whereby "…the same firms that own Airbus Industrie are in the paradoxical position of being subcontractors to an organization of their own creation."[96] Airbus has emerged as an odd, but more effective, variation of *juste retour*. Rather than having each country guaranteed an amount of work commensurate with its stake in the program, countries compete for lucrative Airbus supply contracts. Though this country-based supply relationship falls short of free market principles, it does allow a degree of efficiency necessary to develop unseen in previous programs:

> …[D]espite the specialization of tasks among them, all have retained and even strengthened their own competencies in the major areas of aircraft design, production and marketing, so as not to be placed at a disadvantage in negotiations with their counterparts of the GIE. Therefore, in making its case for the right to build a certain portion of an aircraft and thus receive an agreed-upon compensation, each partner must convince the others that both its methods and its costs are effective and reasonable responses to the challenges inherent in that work.[97]

Airbus is a completely different sort of commercial venture than EADS. First, Aerospace in general is unique, because the excessive costs of market entry present a formidable barrier to most would-be competitors and some coordinated government policy is necessary. However, the Airbus creation worked, in part, because in spite of government involvement, the functions were divided up on a competitive basis: the United Kingdom makes the wings, Germany the interior and fuselage, and France the final assembly. Quite a different problem pervades a company like EADS, which still faces overcapacity with overlapping production facilities in

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96. David Weldon Thornton, *Airbus Industrie: The Politics of an International Industrial Collaboration* (New York: St. Martin's Press, 1995), p. 95.

97. Thornton, p. 169.

each country. The Airbus consortium did not depend on the European countries rationalizing their national industry; it was in effect a rational division of work. The success of EADS, however, depends on the ability of the European participants to cut out excess capacity, presumably through factory closings and layoffs, which is anathema to countries that view the defense market primarily as a source of domestic employment.

Finally, there are also very important political implications to Airbus that extend to the defense industrial base. The Future Large Aircraft (FLA), a long-sought military follow-up to the Airbus, has finally achieved the needed political support to continue. On July 27, 2000, seven European countries signed on to a declaration to buy over 200 of the A400M aircraft. If the project goes ahead as planned, it would become the largest military cooperative program yet.[98] The real test for Airbus, however, will be to see if the member states can continue the successful collaborative policies used with commercial aircraft and apply them to a military project.

Conclusions

It is still too soon to speak of a "Fortress Europe" given the extensive set of ties between European and U.S. defense industry. EADS is already seeking to exploit its ties with Lockheed Martin, while BAE Systems has close commercial and defense ties with Boeing. Recent European competitive procurements have been portrayed as "European" versus "American" projects, but in reality most have had mixed teams. BAE Systems has a large stake in the Joint Strike Fighter, and Boeing will play a role in the development of the Meteor BVRAAM missile. Thomson-CSF and Raytheon cooperate extensively on air defense radar systems, and rumors of a merger have circulated as well.

European companies, however, are extremely sensitive to the imbalance among these partnerships. Aérospatiale Matra and DASA's domestic share of the U.S. defense market, excluding direct exports, is almost zero, and European consolidation may complicate issues of transatlantic cooperation. For example, memoranda of understanding between DASA and Northrop Grumman will have to be reevaluated under the EADS consortium to adjust to Pentagon limitations on the exchange of technical information. EADS' best, and arguably only, hope for gaining access to the U.S. market is through forging strategic alliances with U.S. firms in order to bid on DoD contracts.

In light of these developments, what risks does a "Fortress Europe" pose to U.S. Industry? European companies, no matter what they claim, are not in a position to find second suppliers for many of their parts. Although many companies claim they have a "zero share" of the U.S. defense market, they also benefit through subcontracts and supplier relationships without which they would suffer greatly. Clearly, the risks that Europe poses to U.S. industry are not as stark as often portrayed.

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98. *Defence Systems Daily*, July 28, 2000. Online at <http://defence-data.com>.

On the other hand, maintaining the present course may pose risks to U.S. industry. Europe, by slowly closing its doors, could substantially hurt U.S. companies and, over time, break into third markets currently dominated by U.S. exports. Both sides would lose, but U.S. industry might lose more. An even worse development would be if Europe were to invest in a European force too weak to be independent but able to divert European resources from NATO. Such an outcome could damage U.S. industry by excluding its defense contractors from European projects, and also hurt the NATO alliance as a whole by adding to the debate over burden sharing.

Recommendations for Policymakers

The U.S. government cannot seriously consider the possibility of a transatlantic defense merger while U.S. companies cannot even forge normal supplier relationships with European companies. Transatlantic partnerships alone will not solve the fortress Europe/America problem at a time when even basic issues remain unresolved. The DoD together with the Department of State needs to create conditions that facilitate transatlantic teaming, joint ventures, and strategic alliances.

- The United States needs to make substantial progress in reforming the export control process. Expanding the Defense Trade Security Initiative (DTSI) may not be enough in this regard. European governments, and even more so European companies, are skeptical of the entire U.S. approach to export control. At this point, European companies view DTSI as "fine-tuning" when what is needed is an overhaul. The U.S. approach of "dictating terms" must give way to a more cooperative approach to include multilateral and bilateral negotiations with European governments.
- Current reforms must anticipate increasing harmonization in European export policy. The focus on bilateral negotiations between the United States and individual European countries is shortsighted. At a time when European firms are increasingly transnational, European governments will be looking for agreements from the United States that can accommodate these firms. A recent Defense Science Board report argued for adapting "existing bilateral security arrangements to address the emergence of multinational foreign defense industrial organizations."[99]
- The United States must establish permanent and formal relations between the Pentagon and the European Union. Even though current policy requires negotiations on a country-to-country basis, the Pentagon would benefit from establishing more contact with the EU, particularly the agencies that deal with export policy. Security concerns, export regulations, and security of supply

99. U.S. Defense Science Board, *Final Report of the Defense Science Board Task Force on Globalization and Security* (Washington, D.C.: Office of the Under Secretary of Defense for Acquisition and Technology, December 1999).

could all be addressed on a bilateral basis with the EU, even if just as a mechanism to introduce these policies *through the EU* to member states.

- The United States needs to press for improved NATO-EU relations. This means, first and foremost, taking the EU seriously as an institution and recognizing the increasing role it plays in defense issues. The United States can take the lead in NATO by establishing cooperation between the U.S. Mission to NATO and the U.S. Mission to the EU, both of which are located in Brussels. Washington should look for ways to facilitate permanent contact between the EU and NATO through U.S. leadership, and take the EU seriously as a partner in negotiations. Regular contact would require a permanent working body that could outline clearly the relationship between the EU and NATO, particularly after the WEU is integrated into the EU. Certainly a part of this process would be for the United States and NATO to work with the EU to clarify the role of non-EU members of NATO in the WEU, and in particular, new NATO members (such as Poland and the Czech Republic). Since these new members will alter the balance of voting power within the EU, their position on defense industrial issues could be crucial. From the U.S. perspective, it will be important that new EU members, who are also members of NATO, be able to meet their NATO military obligations prior to participating in ESDP's rapid reaction forces.
- The U.S. should immediately initiate focused discussions with European allies and partner countries on transatlantic mergers. Though a transatlantic merger at the prime level may be several years or more off, it would be prescient for the United States to anticipate events and prepare for such mergers. Many European countries continue to criticize the U.S. Committee on Foreign Investment in the United States (CFIUS). Even though committee investigations rarely lead to a blocked merger or divestiture, the nature of the investigations have soured relations (in particular with France over the Thomson-CSF LTV merger). On the European side, the United States continues to be wary of European ownership, which often includes "golden shares" and extensive cross-ownership. Transatlantic discussion on these issues would allow both sides to anticipate what areas of concern would need to be addressed should such a merger take place.

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