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Research Report

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Restructuring Europe's Armed Forces in Times of Austerity

Challenges and Opportunities for Governments and Industry

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Current budgetary cuts are exerting strong pressure on defence ministries across Europe to reform their armed forces and the way they do business. A look at the situations of Germany, the United Kingdom, France and Poland reveals that policy responses, to date, have remained largely confined to the national or bilateral level. Instead, co-ordinating restructuring efforts and exploiting the options of pooling and sharing capabilities would enhance the potential of European armed forces. For that to happen, policymakers in the EU need to overcome an apparent fatigue with intra-European multilateral co-operation. Against this background, we explore what concrete policy options are on the table to achieve savings whilst pursuing much needed structural reforms of the armed forces and strengthening a European Defence Technological and Industrial Base (EDTIB).

Europe's national defence policies have been caught up by economic realities. Since the end of the Cold War, economic globalisation and the crisis of the welfare state in many Western European states have led to a worsening fiscal situation and a concern for domestic job-loss. This has led to an over-reliance on old defence structures to maintain jobs instead of pushing through long-overdue reforms of the military to adapt in a consequent manner to a novel security environment. From this vantage point, the current financial crisis appears as an opportunity in many member states

for painful but necessary structural reforms.

Is there a crisis?

The crisis that the defence sectors of the EU4 (France, Germany, Poland, United Kingdom) are facing is evidently of an economic nature. But beneath the factual financial realities lies a much deeper political challenge: The European Union is engaged in a strategic coming-of-age that is in part fuelled by Washington's gradual geopolitical distancing since 2005. The new

demanding approach of Washington vis-à-vis Europe reveals a vacuum that EU member states are hard pressed to fill with their own strategic priorities.

Declaratory commitments in the domain of the Common Foreign and Security Policy (CFSP) and the Common Security and Defence Policy (CSDP) have more often than not fallen short of consequent implementation. Thus, the credibility of Europe to make good on its international ambitions is gradually eroding.

Common efforts are needed to overcome this deficit. But an EU-wide fatigue with intra-European multilateral co-operation has become apparent and is currently being exacerbated by the financial crisis. This has become obvious with the recent Franco-British "*Entente Frugale*" of early November 2010 favouring bilateral collaboration of the like-minded.

Budget Constraints in the EU4

Structural reforms of the armed forces.

The four states under study are all affected by budgetary dearth, yet to a different extent. Germany and the United Kingdom are affected the most, with cuts of around 8 per cent looming for the British defence budget and Germany having to comply with its constitutionally mandated deficit ceiling. For France and Poland, developments in their respective national fiscal situations will influence whether more cuts will be considered in the three years ahead.

Twenty years after the end of the Cold War, most EU member states are now seemingly pursuing consistent efforts to enhance the deployability of their armies. All militaries under scrutiny have – or are currently undergoing – a shift towards professionalisation, with Germany being the last, after France and Poland, to consider ending conscription. Challenges encountered in these restructuring efforts are similar: the often overlooked need to tackle head-on a political over-commitment at the international level; which balance to

strike between capabilities in the realm of conventional warfare and those in the realm of irregular warfare and stability operations; how to implement large personnel cuts in a sustainable way and how to deal with compensations and pension claims.

Structural reforms have been presented as a means to achieve savings. Yet, it remains an illusion to hope that two birds can be killed with one stone when it comes to saving money whilst restructuring the military. Financial cuts will per se neither help in the hiring of multitalented soldiers needed for current missions nor bring about the necessary resources to equip the smaller armed forces adequately. Whilst sharing and pooling are options explicitly being considered by the political leadership in the four countries reviewed in order to mitigate the blow of financial cuts, efforts to identify areas for concrete co-operation currently remain confined to bilateral talks (cf. French-British co-operation). In a nutshell, most European governments tend to turn inwards and, before anything else, seek ways of protecting their national defence capabilities and industrial assets from the impact of the crisis. Such policy may be deeply harmful to the further development of European defence capabilities, since it is likely to protect the funding of unsustainable and unnecessary capabilities at the national levels, and thereby further contribute to lowering the overall defence capabilities of Europe by limiting the availability of needed capabilities as well as the deployability and interoperability of forces.

Industrial consequences. It remains difficult to make any final statement as to what extent the EDTIB has been affected by the crisis: Most prime contractors seem to be recovering rather quickly from the first crisis peak. But the fiscal downturn is conditioning serious programme cuts, which still lie ahead for the EU4. These are likely to impact the industry more seriously in the years ahead and will result in stronger competition for contracts within a lower-

demand environment and increased value-for-money imperatives.

To the industry, the lacking consolidation of demand within the EU represents a major challenge: Firms are increasingly interested in consolidating their foothold in the United States, or in developing co-operation with emergent countries. Firms such as Rheinmetall or EADS Defence and Security/Cassidian also re-weighted their business models to abandon certain defence-related production lines to concentrate on civil security (e.g. border control, airport security).

The British defence industry, like others, is exposed to shrinking national demand, but it by and large already restructured itself substantially during the 1990s: By driving down costs and pursuing diversification in the dual-use and security sectors, the British defence industry has become highly competitive at home and abroad. A prime contractor such as BAE Systems has developed a business model based on the diversification of the products and services it offers, which makes it less reliant on the UK customer base.

French defence exports have been stagnating since the beginning of the decade, despite growth in global demand. For the past three years, the French government has been trying to improve the French defence industry's export performance. Meanwhile, it is seeking the necessary funds to maintain the production lines of the Rafale jet fighter and to offset lacking export demand for the model. The government hopes to further consolidate certain segments of national industry champions, whilst pushing for the diversification of their activities in the wider sector of security (Thales and Sagem).

In Germany, economic data available for individual defence firms like Rheinmetall, EADS, OHB and Diehl offers a brighter picture: Most defence firms are starting to show clear signs of recovery from the peak of the crisis in 2008/2009, partly due to recent government efforts to improve acquisition for ongoing deployments, and

in part due to dual-use and non-defence-related activities. Both the Federation of German Security and Defence Industries Association (*Bundesverband der Deutschen Sicherheits- und Verteidigungsindustrie*) and the labour union IG Metall have called on the government to help secure the national industrial basis (core capacities) through targeted national orders and through the shortening of administrative delays for exporting defence goods.

In Poland, an industry strategy was adopted by the government prior to the crisis that involves further consolidation within the Bumar Group, recapitalisation as well as concentration on core business (e.g. tracked and wheeled armoured platforms, munitions, opto-electronics, radars). Yet, the 2009 defence cuts hit those firms severely, since they are almost entirely dependent on the Polish Ministry of Defence procurements, with exports being only a periodic source of revenue. Special financial instruments, mainly governmental guarantees and credits, were needed to save a couple of Bumar companies on the verge of bankruptcy. Nonetheless, Bumar seeks to progressively increase its export revenues.

Save more together?

To tackle the challenges that their governments are tasking them with, professional armed forces in Europe will require additional money even in times of scarcity. The equation "national defence restructuring via the Finance Ministry" thus does not solve issues readily. It costs money to save. Moreover, extra-thinking is required of European policy-makers to find ways to better utilise the duplicated military resources available at the EU level. The political decisions needed to pursue such options and to overcome the inherent challenges involved in multinational endeavours have been on the table for a long time: Pooling and sharing capabilities as well as establishing specialisations in capabilities and divisions of labour are the most prominent ones.

Working more closely together must become a practical imperative if EU member states want to make good on the foreign and security policy goals they have defined as priorities to their citizens. Two important facets of this political challenge are the fatigue with multilateral co-operation on the one hand, and the question of how credibly to organise mutual dependencies (role specialisation), on the other hand.

The multilateralism fatigue

France and the United Kingdom have clearly opted in favour of a bilateral approach out of frustration with the intricacies of multilateral co-operation inside the EU.

In the Declaration on Defence and Security Co-operation during the UK-France Summit on 2 November 2010, London and Paris identified a series of fields for deepening bilateral co-operation and sharing common defence equipment. Certainly, creating an *avant-garde* in which shared interests form the basis for closer co-operation is a legitimate and helpful path in cases of deadlock and should be expected to act as a catalyst for the extension of collaboration. The only concern is that such bilateral solutions must be kept open to other states that have similar interests and the capabilities to join. Otherwise, a sclerotic defence union with unrelated “co-operation clusters” may result in the long run.

Such an outcome would be ineffective and detrimental to the overall political climate in the EU. With the obvious exception of co-operation in the field of capabilities specific to the United Kingdom and France – as nuclear powers and medium-sized maritime powers with global military ambitions (such as co-operation in nuclear testing or the sharing of aircraft carriers) – most items on the agenda of the Franco-British *Entente Frugale* are indeed candidates for expansion to other interested European partners. These partners – with Germany or Poland at the forefront, but also other states – now ought to identify their stra-

tegic interest in joining and define co-operative steps, together with France and Great Britain, which would benefit all. The recent initiative by British Defence Secretary Liam Fox to launch a Forum of Northern European Countries for closer regional concertation in security and defence matters is in that respect an opportunity not to be missed.

Co-ordination opportunities

Meaningful transformation of the armed forces in Europe must, before anything else, come from the nations themselves. However, one option that European nations might consider on that path could be to embark on a collective form of Strategic Defence and Security Review (SDSR) to look at how their efforts to meet the demands imposed upon them by the financial crisis – as well as the effect of cutting military budgets – will influence the use of their combined capabilities within NATO and the EU. The purpose of such a European-level SDSR would be to identify capability improvements specific to each nation as well as to set a target for their co-operative or collective use within the variety of defence organisations that they are a part of.

At the EU level or that of the NATO alliance, member states should take a co-ordinated approach to cuts where appropriate and harmonise them in ways that do not undermine the overall capability of member states in a given domain. Such dialogue should gradually be expanded from the EU4 here under review to include additional states, with a view to guaranteeing that ongoing reforms are engaged in a way that is not harmful to the CSDP in the long run and that would also be consistent with NATO’s new strategic concept.

Ideally, the coherent and systematic pooling of capabilities at the European level would require a shared model of capabilities, including the possibility of having a European budget-planning process for joint capabilities. Considering the lack of wide-scale political backing for such a degree of European integration, intergovernmental

models involving increased sharing and pooling of capabilities as well as some moderate form of role specialisation are more likely to succeed for the time being.

Looking into concrete cases where sharing and pooling could help foster joint capabilities at the European level is a promising endeavour. It will provide food for thought on options to bring about much needed savings and, in particular, more rationality and value for money in the €200 billion business of European defence. The following examples are neither exhaustive nor a priority list.

Options

The European Air Transport Fleet and the A400M. In the field of equipment and capabilities, the United Kingdom and France plan on concluding a joint contract with Airbus Military by the end of 2011 concerning the maintenance, logistics and training relating to the A400M. France is also interested in buying hours from the Future Strategic Tanker Aircraft, a private-finance initiative to replace the Royal Air Force's ageing air-to-air refuelling capabilities (VC10 and Tristar aircraft), since it postponed the procurement of the Multi-Role Tanker Transport.

Without mentioning it, the Franco-British co-operation endeavour thus covers important items identified by the European Air Transport Fleet (EATF) Declaration of Intent (10 Nov. 2008), which states that in order to improve airlift capabilities in the EU the participation of EU member states to the EATF could take the form of making available military transport aircraft; purchasing, providing or exchanging flying hours; and providing and benefiting from shared or pooled support functions.

An option for enhanced savings could be for the other nations participating with EATF that also ordered A400Ms (Germany, Spain, Belgium and Luxemburg) to pool their planes and join London and Paris in their co-operative efforts for training and

logistics. This initiative could represent a budding European A400M fleet for strategic airlift.

A European Air Defence Fleet and launching Baltic surveillance. Eurofighter nations and others could pool a certain percentage of their aircraft to form a European Air Defence Fleet. This would represent another option to jointly save on maintenance and logistics. At the same time, such pooling could favour joint training and become the basis of a division of labour among states to guarantee missions other states cannot cover in the EU. Air policing over the Baltic states has proven the feasibility of such co-operation. Moreover, creating a Baltic Naval and Air Surveillance that involves the Baltic states, Finland, Sweden, Denmark, Germany and Poland could successfully feed from existing capabilities (Eurofighters, Gripen, F18s and F16s) as well as from already proven operational co-operation between Finland and Sweden. It would extend the co-operative experience of NATO's German-Polish-Danish Corps into the maritime dimension.

Maritime mine countermeasures. Another declared field of interest to closer British-French co-operation concerns maritime mine countermeasures. The Franco-British agreement foresees that in 2011 a project team will be created and tasked with defining the specifications for an anti-mine system prototype. The overall aim of the European Defence Agency's (EDA) Maritime Mine Countermeasure Category B Project – of which the United Kingdom is not a part – fully fits the declared intentions of Paris and London: It seeks to prepare the replacement of the current capabilities of 11 EDA participating member states* from 2018 onwards. France here acts as lead nation. Germany has historically showcased a great proficiency in mine-sweeping and certainly would contribute in a meaningful way to closer co-operation with London and Paris on this front and potentially contribute to a stronger start-up core.

* Participant states are Belgium, Estonia, Finland, France, Germany, Netherlands, Poland, Portugal, Romania, Spain and Sweden (+Norway as contributing member state).

UAVs and communications satellites.

The planned assessment in 2011 of the prospects for a joint Medium Altitude Long Endurance Unmanned Aerial Vehicle (MALE UAV) programme to be developed between 2015 and 2020 – another UK-French project – holds promise for co-operation to enable potential sharing of development, support and training costs, and to ensure that French and British forces can work together. Whilst details remain scant on this point, France and the United Kingdom want to assess further the co-operation potential for communications satellites. Yet in the 2020–2030 time frame, such capabilities are also a matter of general European concern, in particular improved SATCOM capacities will be absolutely essential for UAV operations.

Furthermore, the strategic concern of both countries does not emphasise the potential civilian uses of UAV capabilities for homeland security purposes (maritime surveillance, border surveillance), in which a greater number of European partners may be interested. Wider participation in acquiring off-the-shelf solutions may yield lower costs. Again, jointly procuring UAV capabilities and pooling them may fill a strategic need for dual utility both in the military and civilian fields. From an Industrial perspective, a further option for European co-operation beyond the Franco-British interest in MALE UAVs might be to develop lower-altitude medium-endurance UAV technologies.

Towards a European Industrial Policy

Hopes are high that the European Commission's "Defence Package" may bring about – through enhanced competition – a further consolidation of supply. Yet, whilst firms are already re-orientating towards global demand with greater consequences, defence industry representatives have been quick to point out that a meaningful consolidation of demand also needs to take place. The latter may well entail the risk –

seen from a national point of view – of a redistribution of production lines and the weakening of technology bases in European countries.

Despite calls for sustained, targeted national orders, the industry is keen on enhancing its exports. Since a reliance on export-led growth has emerged as the main reaction of most European defence firms to the crisis, the issue of the sustainability of such a strategy will sooner or later emerge. Two dynamics are likely to surface.

First, European firms risk being crowded out of sectors where there is too much European and international competition, thereby driving down income and eventually leading to externally induced consolidation of supply. Especially small and medium-size enterprises will be concerned by this trend and are likely to be less resilient in cases where firms rely to a greater extent on technology transfer to increase export shares.

Second, oversupply may increase the bargaining positions of those states currently purchasing defence goods. Increased transfer of intellectual property rights might be the difference that makes or breaks a deal. If European firms are over-reliant on export strategies, especially towards rising powers, important intellectual property rights may be lost – with ensuing political, strategic and economic consequences. Joint European export support-strategies could be one remedy for the problems likely to arise from an uncoordinated rush to greater export reliance.

Consolidation of demand

It seems unlikely that a stronger reliance on exports on behalf of the industry can be – or even should be – avoided altogether. Yet, greater co-operation between government and the industry could help diversify the industry's strategic approach in the face of the challenges ahead.

The defence industry cannot be required to consolidate without the adequate political strategic direction and impetus. Indeed,

consolidation of demand is a matter of defence policy as well and needs to occur along politically defined strategic lines, possibly based on a joint European Strategic Defence Review. European demand – with harmonised and controlled requirements – needs to be bundled with greater consequence in order to generate revenues and economies of scale accordingly at the European level.

Consolidation can happen either through joint research and technology (R&T) projects or through bundling demand for shared capability needs (harmonisation of demand, synchronisation of procurement, co-operative or common procurement).

Pooling R&T funds. R&T budgets are more vulnerable than most and are at immediate risk of being cut across the EU – in fact, announcements have already been made by Italy, Spain and France. In order to limit the impacts of defence investment cuts on the overall defence capabilities of the EU, pooling R&T funds seem to offer the best solution.

In their November 2010 agreement, Paris and London also decided to further strengthen co-operation in R&T and identified a number of priority areas, divided into time-critical research (satellite communications, unmanned systems, naval systems, complex weapons) and new areas of critical industrial importance (sensors, electronic warfare technologies and materials, as well as simulation). Considering that these fields are equally relevant for the development of most other major European military powers (e.g. Germany, Spain, Sweden, Italy), the reasons why more money should not be put into one pot remain scant. Obviously, the EDA's Joint Investment Programmes have not convinced the United Kingdom of their efficiency, yet.

Joint investment and procurement. Besides pooling R&T funds, common investment and procurement programmes are a fur-

ther option to consolidate demand. Existing programmes, for example the A400M or the Eurofighter, can be assessed only as limited successes. Although they deliver the equipment needed, they also reveal a magnitude of organisational and technical problems, stemming from the political, not economic, character of the primary impulse for co-operation. Thus, the willingness of the EU member states to establish new joint programmes, particularly ambitious ones, is currently reduced.

Yet, international armaments co-operation is not inherently more complicated than national armaments development. It does, however, exponentially augment political and co-ordinative challenges already present at national levels. Close attention is required, first, to the harmonisation of requirements and their controlling so that they do not spiral out of hand and, second, to the shared use of jointly procured capabilities to avoid duplication. Finally, in joint R&T projects, favouring step-by-step developments geared to 80 per cent rather than 120 per cent solutions is bound to contribute to the reduction of the well-known pitfalls of defence procurement, both at the national and international levels. Where it turns out to be adequate, procurement ought to rely to a greater extent on commercial and military off-the-shelf solutions (COTS-MOTS) as well as outsourcing through public-private partnerships or private providers.

An industrial headline goal 2030

Member states need to find common denominators in their approaches to armaments policy in order to define a strategic European industrial policy. Such policy would contribute to the consolidation of the defence industry across the EU by strengthening those sectors in which Europe's defence industries hold a comparative advantage on the global market. Candidates for this type of strategic European industrial policy could be the aerospace (aircraft, UAV, satellites), missile,

naval (including submarines) and protected-vehicle sectors.

Defining industrial headline goals for 2030 could be one step to materialise this kind of strategic European industrial policy. It would be based *inter alia* on the mapping of the European industrial comparative advantages by global comparison as well as on the objectives of appropriate technological sovereignty (where dependencies of the EU are not considered reasonable).

Under pressure from the industry, London and Paris also tacitly agreed on forming a monopoly in the field of nuclear submarine technology. A clear division of labour along the lines of production could be a useful outcome of this trend. In the naval sector, a consolidation at the European level of French and German competencies in the field of conventional submarines could represent one option.

Recommendations

Three major political recommendations address the challenges the EU4 and their partners are facing in these times of austerity.

A common Strategic Defence and Security Review

A European-level SDSR would be a first step to review how efforts by the EU4 to meet the demands imposed on them by the financial crisis and the effects of cuts in military expenditures will influence their capabilities within the EU and NATO. Further, it would allow for identifying capability improvements specific to each nation and facilitate setting a target for their co-operative or collective use.

Encouraging the security-defence diversification in the European defence industry

In order to cushion the blow from increased competition due to stronger export

strategies, firms that are not competitive or not part of competitive sectors should actively pursue portfolio diversification by increasing their reliance on civil security or on dual-use goods rather than solely on defence goods – this may represent the best means to prevent uncoordinated dismantlement of the industry and job losses across the EU. The industry and government ought to consult to devise exit or diversification strategies to this end. Some degree of sector consolidation seems unavoidable, however.

Opening up bilateral initiatives to wider participation

Bilateral solutions must be kept open to other states with similar interests and the capabilities to join. So far, the European Defence Agency – as one of many instruments designed to assist in dealing with the intricacies of multilateral projects – is being sidelined by the observable trend towards more bilateral, rather than multilateral, solutions. Of the EU4, only Poland seeks to strengthen the role of the EDA. The United Kingdom, in its SDSR, does not even mention the Agency, ignoring its role in stimulating capability development, fostering collaborative R&T, enhancing armaments co-operation and guiding work on the EDTIB.

In all four areas, the United Kingdom and other member states see a need to work together with partners – the prominent example being the French-UK agreement, where common capabilities and research activities, collaborative arms projects and industrial initiatives are mentioned. Many of these issues are being dealt with at the EDA – with a variable number of participants. Thus, the flexibility of the EDA as a catalyst for and host of common efforts – irrespective of the numbers of participants – should be exploited.

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