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Safeguarding the EDTIB: the Case for Supervising non-EU FDI in the Defence Sector

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It is time for the EU member states to start collectively supervising non-EU FDI in Europe's defence industries and infrastructures. This should be a prudent element of the nascent EDTIB and a way to maintain European security by encouraging greater coordination between the national supervisory frameworks.

Introduction

The European Defence Technological and Industrial Base (EDTIB) is a key factor in the European Union's (EU) ability to become a credible international military actor. The underlying logic of the EDTIB is to deal with the structural economic shifts in the European and global defence industry by fostering the development of defence industrial capabilities, security of supply between countries, increased competition in the defence equipment market, deepening and diversifying supplier base and increased armaments cooperation. However, if the EDTIB is a fundamental building block of the Common Security and Defence Policy (CSDP), and, as the High Representative has stated, it is indispensible from a strategic and economic point of view, a number of recent and longer-term developments should give pause for thought.

Indeed, the combination of the need to re-structure Europe's fragmented defence sector and the fiscal consolidation brought about by the eurozone crisis is pushing some member states to undertake the privatization and sale of industrial assets. Foreign Direct Investment (FDI) – through shareholdings, mergers and acquisitions made in and with third-countries – by non-European strategic competitors is a particular challenge for the EDTIB. Policy-makers have the unenviable task of balancing the need to re-structure the EU's defence industry whilst also maintaining European security. This policy brief inquires into the management of this balance, before then outlining a number of possible models that could be used as an EU-level supervisory framework to better protect the EDTIB.

Protecting Your Base

The role of military science and technology is essential to the survival of any political community. Just as the Germanic tribes used the horseshoe to overcome the bogs and marshes that would see them repel the onslaught from Roman legions, so do drones make the task of finding suspected terrorists in places such as Pakistan and/or Afghanistan easier by circumventing mountains and inhospitable terrain. For such technological advances to occur there need to be effective institutional-industrial mechanisms in place.

Combined with the need to rationalise a long fragmented defence sector in the EU, the steps to nurture the EDTIB as a foundation of the CSDP is a response to the need for such mechanisms. Indeed, when EU ministers agreed to establish an EDTIB in 2007 they did so to underpin the CSDP and thus the EU's security and strategic "toolbox". The Base is designed to supply the EU with cutting-edge technology and defence equipment, and to do so in such a way as to maintain the EU's defence independence and to take advantage of possible economic opportunities – for example, by developing dual-use technologies with civilian application. As European Commission Vice-President Antonio Tajani has put it, 'defence markets are fundamental in giving Europe greater independence and sovereignty in defence' (2011).

The EDTIB is also a response to festering structural imbalances in Europe's defence sector. The critical problem in the EU's defence sector relates to costs and the impact of such costs on economic growth potential, particularly since the eurozone crisis. The globalization of military supply chains and the "peace dividend" of the post-Cold War period, which has led to less demand from the EU and the United States, have indeed resulted in high and volatile equipment costs. As defence markets and rationalization efforts are still largely fragmented in the EU - with the resulting market congestion, duplication of spending on Research (R&D), rival projects and short production runs - coping with such costs has elicited a number of different responses from the member states. The first such response has been to reduce defence spending. With the exception of some member states, the EU average share of GDP spent on defence declined from 1.7% in 2001 to 1.4% in 2010 (Ecorys, 2010). This is thus below the 2% minimum required of NATO members.

The European Commission has sought to facilitate further cost savings by adopting and promoting, *vis-à-vis* the member states, its "Defence Package" with two Directives aimed at simplifying intra-EU defence equipment transfers and defence procurement procedures. The Commission believes a European defence industrial policy should, among other things, promote competition, liberalization and innovation. It wants to de-fragment defence markets at the national level, by integrating certain defence-sectors within the internal market, in order to overcome the high degree of regulation and duplication in defence-related industries and to boost Europe's global competitiveness. The Commission has been keen to seize on reduced defence budgets and high research costs to push for more defence industry integration. However, a second response by the member states – in many cases encouraged by the Commission – has been to privatize and sell defence industrial infrastructure in the highly indebted countries. This further adds to the problem of states not even owning 'the industry required to produce' defence capabilities (Mölling & Brune, 2011: 10).

Sales of such infrastructure to EU member states cannot be objected to in the internal market, and to some degree such developments play into further consolidation of the EU's defence market (e.g. the proposed BAE/EADS merger), even if national legal safeguards under Article 296 of the Treaty of the European Community can still be used during the acquisition period. Indeed, intra-EU acquisitions of defence firms form the bulk of infrastructure sales. As one can see from Figure 1 below, from 2007 to 2009 the majority of reported acquisitions for European arms producing companies have come from the EU. None of the emerging powers such as Brazil, Russia, India and China rank among the list of acquisitions from 2007-2009. The United States (US), a defence industrial competitor, ranks second highest in terms of the value of acquisitions at US$ 5,336 million.

FIGURE 1 - ACQUISITIONS OF EU-BASED ARMS PRODUCING COMPANIES, 2007-2009

Firm location	*Total No.*	*Total approx. value of deals (US$ millions)*
EU (total)	36	10,647
United Kingdom	21	6,598
United States	12	5,336
France	5	3,809
Germany	4	128
Spain	2	50
Canada	1	33.5
Italy	1	30
Sweden	2	25.6

Source: SIPRI, 2012

However, any future sell-offs to non-European states should necessitate greater scrutiny. Indeed, there are a number of planned privatizations. For example, by the end of 2012 Greece's *Hellenic Defence Systems* (HDS) defence manufacturing company and Portugal's *Viana do Castelo* (ENVC) shipyard will be privatized and potentially sold to non-European bidders. While ENVC's commercial viability has long been questioned, and the yard has only produced two military frigates in its history, any foreign buyer can take advantage of the relatively high-tech "know-how" accumulated by the yard. Of more concern should be the sale of HDS, as the company is not only in the business of producing weaponry ranging from shotgun cartridges to large calibre Greek patriot missiles but it is also a NATO certified Missile Assembly Disassembly Facility. Valuable classified information and procedures should not be handled so lightly, and neither should the risk of supply security. The same is equally true of the acquisition of *Deltamarin* - a Finnish naval shipbuilding company – for US$ 51 million in October 2012 by China's state-owned Aviation Industry Corporation of China (AVIC).

The outflows of military know-how through non-European inflows of FDI are therefore a concern, especially if non-European firms are state-owned. Indeed, emerging economies are using the eurozone crisis to tap into new European markets, to expand production chains and to increase human capital and technological know-how. While private firms such as Huawei Technologies and Lenovo Group are responsible for the 'overwhelming majority of deals' in the EU (80% to be exact), the value of FDI deals made by State-owned Enterprises such as the China Ocean Shipping Group Company in the EU rank higher in terms of overall value. Aside from these commercial, non-military, investments there are still potential security risks. For example, while Chinese FDI in the EU obviously pre-dates the eurozone crisis, it has been estimated that in 2011 China's major FDI assets included US$253 million in aerospace, defence and space and US$1,357 million in communications, equipment and services (Hanemann & Rosen, 2012: 45-46 & 41).

Some readers will perhaps argue that FDI in Europe brings new capital, employment opportunities, boosts productivity and that it serves as a means to bring countries such as China in line with EU standards through the Single Market. Others might argue that the EU does not really have to worry about FDI exposure to emerging economies in the short-term, given that both overall FDI inflows and outflows have decreased since 2007 (inflows have decreased by approximately US$436

billion; outflows have decreased by approximately US$555 billion (OECD, 2012). Going further still, and with some justification, others could point out that to single-out states such as China as a threat to the EU's defence industrial infrastructure is not quantitatively supported given that in 2010 the US was still the largest FDI investor in the EU followed, in order of investment value ranking, by Canada, Hong Kong, Switzerland, Brazil, Japan, China, India and Russia.

Nevertheless, there is a lack of coordination between the EU member states on the process of privatization. Indeed, as yet there is currently no European-level framework for the screening of FDI. In fact, FDI screening is fragmented at the national level which leads to a "race to the bottom" as national procedures favour "short-cuts" in order to secure short-term economic gains (IAI *et al*, 2010: 325). So far only ten EU member states have FDI restrictions of some kind in place for the defence, transport and telecommunications sectors and Lithuania is the only member that has an outright prohibition on FDI in defence and security from non-EU and non-NATO members. This situation has led to a number of calls for a European-level supervisory body – not least from the European Commission - to look at internal market and trade supervision for areas such as defence and critical technologies, among others. The second part of this policy brief turns to what a framework for supervision of non-European FDI could look like.

An EU Model for Protecting the EDTIB

In 2007 Michael Brzoska wrote an extremely prescient report in which he outlined both the risks of not protecting the EDTIB, and some of the rudiments of a potential supervisory framework. As he explains: 'while an increasing number of cautious activities for nurturing a European approach to defence technology-generation and production capabilities in Europe are apparent, there are no similar initiatives for protecting these capabilities from foreign control or ownership on the European level' (Brzoska, 2007: 11). As he continues, 'because of the double risk of losing out on competitiveness and of European control, the current focus on improving competitiveness should be balanced by the development of a policy and instruments for the protection of crucial assets' (*ibid.*). Yet a number of EU member states have no formal policies that protect their respective defence industries from non-European FDI. The European Commission has recognised the importance of an absence of such policies.

An informal letter sent by the Commissioners for Industry and Entrepreneurship, Antonio Tajani, and the Internal Market, Michel Barnier, raised the idea of establishing a high-level committee to vet FDI bids for European companies. As Tajani has stated: 'we have decided to raise this issue because it is very much felt. I am highly favourable to non-EU investments in Europe, but I do not want these to mask attempts to close down businesses after having stolen all of their "know-how"' (European Commission, 2011). The Commissioners recognise that states such as Australia, Canada, China, Japan, Russia and the US have similar vetting procedures in place, and the model tabled by the Commissioners would resemble that of the US, 'which has an organism that evaluates non-US investments to see if these impinge on national security or contradict American norms' (*Ibid.*). The Commission has confirmed that looking at ways to vet FDI on the basis of security concerns would be well within the EU's right.

Protection of any defence technological and industrial base, according to Brzoska, can take four main forms – i) demand side measures - states can buy their own defence equipment and restrict non-government procurement; ii) market measures – states can subsidise domestic firms and fund R&D programmes;

iii) supply side measures – the state can serve as a regulator of foreign ownership; and iv) ownership measures – the state can buy-up domestic defence firms or maintain ownership through "golden shares". It is clear from the sentiments of the European Commissioners, and in line with maintaining open markets in the EU, the most favourable would be supply side measures such as the regulation of foreign ownership.

Such regulation would require a body responsible for FDI vetting. One such body that could be used as a template, the "organism" referred to by the European Commissioners, is the US Department of the Treasury's *Committee on Foreign Investment in the United States* (CFIUS). The CFIUS works to vet potential acquisitions for: i) "supply security threats" – to safeguard against non-American buyers that could eventually restrict defence supplies to the US; ii) "technology transfer threats" – to protect against non-American buyers that could use acquired technology to harm US security interests; and iii) "SIS threats" – to defend against a non-American buyer that could use an acquired defence firm for Surveillance, Infiltration and/or Sabotage against the US (Moran, 2009: 4). Protection against such threats in the EU could be elaborated on the basis of four models:

- "The Prohibition Model": as occurs in Finland, Lithuania and Slovenia this would imply an outright prohibition on all non-EU and non-NATO FDI in the EU's defence, aerospace and security sectors.
- "The Approval Model": as occurs in Austria, Denmark, Poland, Spain and Sweden any foreign investors (including those in the EU) must first receive government and ministerial approval for the acquisition deal.
- "The Review Model": as occurs in France, Germany and the United Kingdom acquisitions by foreign firms may be subject to review by the competent ministries and government ministers.
- "The Supervision Model": as occurs in the United States, "Proxy Boards" comprised of EU nationals would run and monitor foreign-owned EU firms.

Each model, however, would have its drawbacks and policy-makers would still need to ensure a balance between market openness and protection. "The Prohibition Model" would quickly lead to accusations that the EU is being protectionist, which could escalate protection measures in third-countries. "The Approval Model" and "Review Model" would be accused of being too arbitrary and discourage all FDI investment as well as trade retaliation measures in third-countries. The impact of "The Supervision Model", as has been the experience of the US, is that non-EU firms may not enter the European market and it may cause a barrier to mergers (Ecorys, 2010: 300). In this regard, while 'Europeans need credible policy instruments of their own to ensure inward investment does not put their security at risk' the EU will want to ensure any model remains open, comprehensive and sustainable and not resort to trade and competition policy mechanisms (Röller & Véron, 2008: 6-7).

For Röller, Véron, Hanemann and Rosen the best model would be a modified version of "The Review Model". Indeed, all of these scholars state that the establishment of a common European legislative framework would be ideal, but that the model would also have to provide EU member states – especially those without any procedures whatsoever – with a blueprint for national review processes. As Röller and Véron (2008) state, any EU-level legislative framework could be established by way of a European Commission Directive even if it would no doubt require great efforts on the part of EU member states to engage and adopt such legislation. The Commission would be well placed to push for such legislation given the EU's new exclusive

competence in FDI under the Lisbon Treaty, even if member states still hold exclusive competence over national security. However, a modified "Review Model" would be best-suited and the Commission and the Council of the EU could each play a role in the vetting procedure through a dedicated body.

CONCLUSION

There is a certain need for the EU member states to put in place a supervisory mechanism that monitors non-EU FDI in European defence markets. Presently, the need to invest political capital into such a mechanism will appear unnecessary given the much larger economic problems facing the eurozone and the EU. Others will argue that the establishment of an FDI protective framework will amount to EU intervention in the economic and defence policies of the individual member states. The prospects of intervention by a supranational authority or through intergovernmental procedures may hinder the chances for such a mechanism even further. These are all valid, if misguided, points especially when one considers that in the vast number of member states national supervision frameworks are non-existent, or they are weak at best.

Given the steps already taken by the member states with regard to assigning the EU greater competence over general FDI, and the efforts to boost intra-EU liberalisation of defence markets through the auspices of the European Commission, the prospects of the member states working to protect the EDTIB is not impossible. Fostering a more efficient internal defence market, and protecting against harmful non-EU FDI into critical defence infrastructures, go hand-in-hand. Just as mutual fiscal surveillance is increasingly becoming important in eurozone governance, so too must mutual strategic surveillance come to pass under the CSDP. Even if a fully-fledged supervisory body does not come into fruition, putting it on the EU agenda may at least serve to improve national procedures.

Therefore, defence and economy ministers in the Council should first arrange for informal information exchanges on national FDI supervision practices. They could then eventually move to informal discussions of planned FDI deals in the defence sector and study the mutual EU impact of such deals. Finally, after some time the ministers could address the idea for a suitable mechanism. Outright prohibition of FDI would be rightfully discounted, but serious thought should be given to approval and supervision mechanisms over the longer-term. The "selling-off" of critical defence infrastructure to non-EU investors is no longer a purely national concern. As the name suggests, the EDTIB is a mutual strategic concern.

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