

Issue paper #1

Towards a European Defence Industrial Strategy: overall consultation paper

The purpose of this note is to support the informal discussions with stakeholders. It does not constitute an official position of the Commission and does not pre-empt the content of the future Strategy.

The return of high intensity warfare in Europe reflects a *steady deterioration of the geopolitical environment at a global scale*. The Union's surroundings are increasingly plagued by increasing tensions, entrenched instability, and armed conflicts. Their escalation at regional and global level cannot be excluded. The level of threat to the security of the EU and its Member States is and will remain high while the rules-based global order is challenged to its core. The EU and its Member States are confronted with hybrid threats, including the targeting of critical infrastructure, and their access to the cyber, space, air, and maritime domains is increasingly contested. In the meantime, the international order is also impacted by the global race for technological supremacy requiring ever faster and increasingly costly investment cycles. In all these areas, no Member State can act effectively alone, whilst the EU simply cannot afford falling behind.

As highlighted in the Strategic Compass and the post-Versailles agenda more broadly, the Union and its Member States are left with no other choice than preparing to confront the worst-case scenario, adopting a more assertive and deterrent geopolitical posture, strengthening their defence 'readiness' and investing in capabilities by developing the European Defence Technological and Industrial Base (EDTIB). By strengthening the European defence industry and armed forces capabilities Member States can deter adversaries and ensure the security of our citizens, while also strengthening the EU's role as global security and defence actor. Ensuring lasting capacity of the European industrial base to deliver required defence products at speed and scale to EU Member States' Armed Forces, in all circumstances, is at the core of Europe's resilience, deterrence and readiness.

However, as emphasized in the Defence Investment Gaps Analysis presented in May 2022, *the Russian war of aggression against Ukraine has crudely exposed that the EDTIB remains affected by weaknesses* resulting primarily from uncoordinated and insufficient defence investments as well as persistent fragmentation along national lines. This fragmentation prevents the EDTIB from exploiting economies of scale, while the lack of coordination has resulted in competing orders that provoked tensions in the cross-border supply chains. Moreover, there is an urgent necessity of a rapid industrial ramp-up to support Ukraine as well as to replenish and upgrade the national inventories, stocks and capabilities. The implementation of the ammunition initiative also evidenced that Member States have little visibility on the overall capacities of the supply chains structuring the EDTIB, preventing them from making informed decision and at the right level. Paradoxically though, interdependences are a reality in lower tier of the supply chains.

The response of the EU and its Member States to the immediate challenge of the Russian war of aggression against Ukraine has been rapid and decisive, inter alia through: the work of the Defence Joint Procurement Task Force; the Instrument for the reinforcement of the European defence industry through common procurement (EDIRPA); the three-track initiative on ammunition – with support from the European Peace Facility (EPF), and the Regulation on supporting ammunition production (ASAP)).

However, it is now *time for the EU to move from the emergency response to building the EU's long-term readiness*. This implies a collective engagement by Member States and industry on the right priorities and with steady action. **It is key to foster the emergence of such a collective commitment through a new partnership and deepened cooperation at EU level.** With a war raging on our

doorstep, it is necessary to underpin a modern and resilient EDTIB by consolidating the actions for the continuity of the EDTIB reinforcement after 2025. The European Defence Industrial Strategy should give further impulse to a paradigm shift to defence industrial readiness.

Against this backdrop, the Commission, together with the European External Action Service in coordination with the European Defence Agency, launches a comprehensive stakeholder engagement process to inform the new European Defence Industrial Strategy. This paper outlines key issues and questions for further discussion in this context.

1. Member States' defence spending has recently started to increase but their efficiency is still to be substantially improved.

Since the start of Russia's war of aggression against Ukraine, Member States have **substantially increased defence investments** (+12% between 2021 and 2022), only starting to compensate decades of under-spending. Further increases materialised in 2023. According to latest available data (NATO estimates for 2023), the 22 EU Member States that are also NATO Allies have increased their defence expenditures by 19% between 2022 and 2023 as well as their equipment expenditures by 43% over the same period. Even though Member States spend more on defence, this does not necessarily mean they spend better i.e., more efficiently and cooperatively.

This situation leads to a European defence industry that is undersized because of past underinvestment – the dividend of peace - to cope with the massive and sudden increase in equipment demand linked to Russia's war of aggression against Ukraine and the urgent need to replenish inventories and stockpiles. If defence investments are not realised in a more cooperative and coordinated manner, the risk is high – as it has been the case for ammunition – that they provoke and/or worsen a supply crisis by encouraging price-spiralling and crowding-out effects for concerned defence products. As a consequence, the impact of increased investments would be dulled or even nullified.

In line with previous analyses, three main issues can be identified:

- **Shortcomings in the early identification of needs and lack of transparency about long-term procurement planning** deprive industry of predictability of potential demand. Indeed, the lack of predictable firm orders and the risk of ramp down impede necessary investments in production capacities. The 2023 revised Capability Development Plan (CDP) is expected to provide a better picture of Member States' overall priorities for the coming years. It is key to identify which ones among those are likely to materialise in procurement, especially in joint procurement, notably based on the work carried out in the CARD (Coordinated Annual Review on Defence) framework. The early identification of supply shortfalls and bottlenecks requires the anticipation of military needs, their translation into and synchronisation with national defence planning and budget cycles, including the definition of critical short-term priorities, for which rapid action must be taken. These priorities should also be made visible to the EDTIB.
- **Member States are not sufficiently coordinating their defence spending and procurement plans, including through the harmonisation of requirements.** Faced with the deterioration of the international geopolitical landscape, Member States try to refill stocks and expand their fleet of existing systems (such as air defence systems) driven by the common sense of urgency, but not systematically considering the benefits of coordination, joint acquisition and/or maintenance, pooling and sharing, as well as solidarity with other Member States. Member States' Armed Forces and planners tend to over-specify solutions sought, which often implies increase of costs and

delays. The result is a lack of harmonisation leading to a continued fragmentation of the defence industry along national lines. Faced with such a fragmented demand, the EDTIB cannot benefit from the potential economies of scale, included those offered by the Internal Market.

- **Aggregation of demand through joint procurement is insufficient.** Multinational armament cooperation is still complex and requires increased efforts in initiation and implementation. At EU level, EDIRPA has been designed to offset such efforts, but it is a temporary instrument and will end in 2025. In addition, several Member States lack administrative capacity to handle the participation in complex procurement processes. This can favour the choice of off-the-shelf procurement from third countries (e.g., through Foreign Military Sales (FMS)) or lead to non-competitive national procurement. Given the depletion of existing stocks, further military measures to support Ukraine will likely need to be procured. The High Representative's proposal for a Ukraine Assistance Fund under the EPF (currently under discussion) could act as a catalyst for joint procurement from the European defence industry.

Such shortcomings and uncoordinated investments result in a series of missed opportunities for the EDTIB. For instance, Member States' arms imports increased by 38% in 2022 (SIPRI Importer/Exporter TIV Tables). According to a recent study (Maulny, ARES Group, 9/2023), 78% of procurement spending from June 2022 to June 2023 resulted in purchases from outside the EU. Even when competitive European products are available, Member States procured non-EU solutions. US Foreign Military Sales in Europe have increased by 89% between 2021 and 2022 (Center for International Policy, Security Assistance Monitor). Moreover, emerging armament manufacturers such as Turkey and South Korea have entered the EU market. This has translated into increased fragmentation, more external dependencies, and less interoperability thus significantly harming the economic efficiency of the sector and potentially even the effectiveness of cooperation between Member States' Armed Forces.

Questions:

- ⇒ How can we improve the predictability and visibility of the European demand for the EDTIB?
- ⇒ How can we achieve a better coordination of defence spending at EU level, including by making best use of PESCO and CARD as well as of the EU budget?
- ⇒ How can we further promote the use of joint procurement? Is there any concrete issues that need to be addressed within the defence procurement directive in times of high tensions?

2. The protection of contested strategic domains requires massive and coordinated investments that exceeds the capacity of any Member State alone.

The Strategic Compass pointed it out: the Union's free and unfettered access to and freedom of action in global strategic domains (i.e., the maritime, air, space and cyber) is increasingly contested and needs to be better secured. It is clear that, even with significantly increased defence budget, no single Member State can invest alone in all the necessary capability and enabling infrastructures. These strategic enablers have hence a clear European interest and dimension. By their very nature, they require a massive pooling or coordination of investments including from relevant EU-level programmes and instruments:

- **Cyberspace has become a field for strategic competition,** at a time of growing dependence on digital technologies. To maintain an open, free, stable, and secure cyberspace the EU has to be able to perform the advanced detection of and response capabilities to increasingly sophisticated cyberattacks. As announced in the EU Policy on Cyber Defence, an embryo of such an infrastructure has been proposed in the framework of the Cyber Solidarity Act through

a European infrastructure of Security Operations Centres (SOCs). It is important this is agreed by Member States within the Cyber Solidarity Act and complemented with a military counterpart, building for instance on existing initiatives (such as the network of military Computer Emergency Response Teams - MICNET).

- **Space is critical for the strategic autonomy of the EU and its Member States.** The functioning of economies, citizens, public policies and security and defence organisations increasingly relies on space-related services and data, including those in the field of security and defence, as demonstrated by the unjustified invasion of Ukraine. Yet, as recognised in the EU Space Strategy for Security and Defence and the Strategic Compass, in a context of growing geopolitical tension, space is increasingly contested. Against this background, while recognising space as a global common, privileging international cooperation and promoting responsible behaviours in space, the EU needs to strengthen its strategic posture and autonomy in the space domain and to take significant steps to protect and enhance the resilience of EU space systems and services (such as Galileo, Copernicus & IRIS²), as well as to strengthen the use of space as a key enabler for security and defence. In particular, threat detection, identification and characterisation (Space Domain Awareness) is key to ensure the EU's and its Member States' resilience in space.
- **Secure access to the high seas and maritime lines of communication, as well as the integrity of the seabed and critical infrastructures at sea (e.g., communication cables) are increasingly threatened.** Given that EU Member States together have the largest exclusive maritime zone in the world, the EU faces unparalleled challenges to protect its maritime interests and infrastructures.
- **The Russian missile attacks on Ukrainian cities and energy infrastructures have shown how critical air and missile defence is to ensure the security of our territory and populations.** Existing European air defence capabilities have demonstrated their effectiveness, and the development of endo-atmospheric interceptors and early-warning capabilities are currently supported by the European Defence Fund (EDF). However, these capability bricks will need to be deployed and used in a coordinated way and, where appropriate, in line with NATO doctrine, concepts and standards to provide effective security to the continent.

Questions:

- ⇒ How to jointly identify European defence infrastructures and strategic enablers to protect the EU's free and unfettered access to and freedom of action in contested domains?
- ⇒ How to ensure that strategic enablers required to ensure safe and unfettered access to contested domains are available at the EU level?
- ⇒ What could be the added value of EU support to these projects? Could they materialise into European flagship projects?

3. Nearly two years after the beginning of Russia's war against Ukraine, the EDTIB has still not fully undergone its necessary transformation.

The Defence Investment Gap Analysis and Way Forward Joint Communication of May 2022 highlighted an industrial gap aggravated by Russia's war of aggression against Ukraine. Tensions on the supply side can be expected to further worsen in light of the further deterioration of the security context, for instance following the current conflict in the Middle East, notwithstanding other geostrategic tensions throughout the globe. In addition, inflation caused by tensions along supply chains further limits the marginal impact of additional investments in manufacturing capacities. Measures adopted at EU level

since 2016 have tackled several facets of this industrial gap. In particular, the EDF, as the EU's flagship defence industrial initiative, is starting to make its mark on the collaborative effort within the EU defence sector. However, more could and should be done by widening the scope of the EU action. At least five structural issues should be addressed:

- **Ensuring that the EDTIB can meet Member States' demand in time and scale (industrial availability of defence products) remains a challenge.** The EDTIB can deliver high-end defence products along the full spectrum of capabilities required by Member States. However, after decades of underinvestment, the EDTIB produces redundant defence equipment in limited quantities and with long delivery lead times. Such a fragmentation of the supply makes ramping up efforts costlier, reduces the visibility for Member States of the EDTIB's overall capacity to meet their demand and hence further deprives EU-based industry from orders and opportunities. European defence industry investment decisions tend to be risk-averse, overly relying on the existence of firm orders, which are generally made on a national basis. To match the increasing competition of traditional and new non-EU players, this trend must change and the EDTIB needs to be incentivised to ramp up its production capacities and reduce its delivery lead time when it is required through de-risking of productive investments. Channelling Member States' investments into the EDTIB is highly dependent on the capacity of the latter to meet their demand in time.
- **Industrial availability should come together with the preparation for the long term, through sustained efforts in R&D&I.** With the increasing cost of innovation of state-of-the-art capabilities, no single MS can afford to develop, produce, and sustain, on a purely national basis, the whole spectrum of defence capabilities. Also, it is key that the current development cycle of complex weapon systems better takes into account the ever-faster pace of technological innovation. In addition, innovators in different sectors, especially SMEs and start-ups, pay an excessive entry cost into the defence market (e.g., security of information requirements), making the uptake of innovation more expensive and longer. The EDF has been precisely designed to enable more cooperation between undertakings and to kick-start the cross-border structuring of future defence supply chains. As EDF focuses on the Research and Development cycle, *it is imperative now that EDF-supported projects lead to or are integrated into defence capabilities effectively procured by Member States. This calls for a more strategic steering of EDF.* In addition, the potential re-nationalisation of defence investments puts at risk current efforts at EU level to ensure the long-term competitiveness of the EDTIB. Recent crises have also shown that extra-EU supply chains, even with like-minded partners, may be subject to different priorities when an emergency arises.
- To ensure the capacity of the Union's industry to manufacture high-end products, it is **essential to master and protect critical technologies for which the EU and its Member States cannot afford to be dependent on non-EU sources.** As underlined in the Joint Communication on Economic Security Strategy and its related Recommendation on critical technologies, the Commission and Member States will first need to jointly assess the risk for these technologies and may then take appropriate mitigation measures including promotion (financial or regulatory support), protection from potential external threats such as foreign investments or leak of know-how and partnering with countries who share our concerns and common interests. Efforts in this sense are still primarily national and would require increased coordination, such as in the field of dual use export and Foreign Direct Investment screening. In addition, while innovation increasingly originates from civilian sectors, non-traditional defence actors (startups, research institutes, etc.) face barriers to enter the defence sector (e.g., high costs, absence of knowledge of the sector's specificities).

- The **too limited integration of the defence Internal Market** (for instance, the lack of uptake of harmonised General Transfer Licences under Directive 2009/43/EC) and the existence of specific national security regulations generates **risks in terms of Security of Supply for both industrial supply chains and Member States, further discouraging cross border cooperation**. The situation is further exacerbated in crisis situations, especially if no contingency plan has been foreseen beforehand. Tensions can arise on specific components or raw materials and defence orders are not necessarily prioritised due to competition with the civil sector. This is a significant disadvantage compared to partners and allies (e.g., the US can activate the Defence Production Act). Considering the cross-border externalities in particular down in the supply chains, only an EU coordinated approach can address these types of issues.
- Strengthening the EU defence industry, in addition to efforts **to enhance cooperation between the European and Ukrainian defence industries**, would represent a core element of EU's future security commitments to Ukraine which will help Ukraine to defend itself, resist destabilisation efforts and deter acts of aggression in the future.

Questions:

- ⇒ How can we improve the industrial availability of defence products manufactured by the EDTIB in the short, medium, and long term?
- ⇒ How can we design and implement an effective security of supply regime within the Internal Market, in particular when a crisis occurs?
- ⇒ What can we do to prepare the integration of the Ukrainian DTIB into the EDTIB?

4. Mainstreaming a defence industrial readiness culture at EU and national levels is an imperative.

To contribute to the EU's defence readiness, the EDTIB needs to rely on a favourable economic and regulatory environment, including access to finance and skills. To ensure such favourable conditions it is important that, for instance, EU policies not related to defence do not trigger unintended negative effects on the EDTIB, but rather contribute to support the development of the defence sector, given its strategic importance. Mainstreaming a defence readiness culture into EU policies could help addressing the challenges currently faced by the EU defence industry, as well as fostering new opportunities for the sector.

- Despite an obvious degradation of the strategic and security context, **access to public and private financing remains a key challenge for EU defence industry**, in particular for SMEs and mid-caps, which form the backbone of supply chains and are key innovation actors. The reluctance from investors (including public investors such as the EIB) to invest in/lend to defence industry is mainly based on interpretations of Environmental, Social and Governance ("ESG") criteria that do not recognise the key role of defence for the resilience, security, and innovation in the EU and that often result in unjustified exclusion of defence activities. There is a lack of recognition for the growing climate and sustainability efforts within the European defence sector, as the armed forces and defence industrial companies are contributing to the green energy transition. The Joint Communication on a new Climate and Security Nexus acknowledges the importance of the defence industry as an important partner for the climate adaptation and mitigation efforts of Member States' armed forces.
- The **EDTIB faces a substantial skills shortage, both for R&D and production**. This shortage is worsened by a perceived lack of attractiveness of the defence sector for new generations. It

cannot be overcome by the industrial companies themselves, and there is a risk that this could lead to wage price inflation and associated increased costs in the sector, a lack of competitiveness and ultimately to a weakening of the EDTIB, with the consequent inability to meet the required ramp-up.

- **The regulatory environment could create additional disproportionate hurdles for EDTIB operations and business plans.** As the EDTIB is an integral part of EU industry, it may be subject to EU and national regulations that have a general scope. The defence implications of these regulations are not necessarily considered from the outset. One of the main difficulties is often to precisely identify the origin of the obstacle faced by the defence industry. At the same time, adherence to e.g., EU environmental regulations is necessary to deliver on common societal objectives.
- **Whereas the defence industry is *de jure* eligible to most of EU funding programmes (e.g., Cohesion Funds), it is generally under-represented among supported projects.** The lack of awareness of the possibility to support the defence industrial sector through these EU instruments contributes to this situation.

Questions:

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| <ul style="list-style-type: none">⇒ How can we improve the social recognition of the key role of the defence industry, for the resilience, security, innovation, and economy of the Union?⇒ How can we enhance the EDTIB's access to finance (including EU structural funds) and adequate skills?⇒ Are there regulatory hurdles at EU level hampering the EDTIB's ability to contribute to the EU defence readiness? If so, which ones? |
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