PART 2

Transatlantic Defense Cooperation: Benefits, Risks, and Barriers

Although there are significant economic, political, and technological benefits in pursuing transatlantic defense cooperation, considerable barriers remain. Moreover, the mix of incentives and risks for governments and business to cooperate varies according to whether the project is spearheaded by government or industry. Once a decision has been made in favor of a cooperative program, however, success will depend critically on the ability of both sides to overcome the wide range of political, legal, and other technical obstacles.

The Decision to Cooperate

Governments and industry consider a wide array of issues before deciding between a national program and an alternative strategy involving transatlantic cooperation. The anticipated benefits can be tangible or intangible in nature and secured in either the short or the long term. Companies and governments must also weigh the potential risks of cooperation against anticipated gains.

One reason governments pursue cooperation is to obtain "better value for money." Governments and industry also pursue cooperation for strategic reasons, as a means of fostering a bilateral/multilateral relationship among capitals or among companies to bank support for a future joint venture or partnering. Still another reason may involve an attempt at fence-mending, such as smoothing over strained relations in a situation that threatens a larger, imminent interest shared mutually by governments or companies.

Some of the key considerations for U.S. and European governments and industry when deciding whether to pursue or eschew cooperative programs are described below.

Government-led Cooperation

U.S. and European governments ultimately become engaged, or not engaged, in cooperation for a variety of political, economic, and strategic reasons. The precise mix of motives can vary widely, depending on the international environment, the state of U.S.-European political relations, domestic political and economic factors,

and the type of proposed defense cooperation. In the past, cooperative efforts involved several considerations and goals:

- *Promote broad national security and foreign policy goals.* Transatlantic defense cooperation can be an instrument to achieve broader national security and foreign policy goals. In both the United States and Europe, transatlantic programs may be seen as an essential and useful complement to diplomatic instruments, bilateral and multilateral agreements, and exchanges among companies resident in allied and friendly countries.
- *Strengthen military coalitions in anticipation of future crises.* For both the United States and Europe, cooperation may reflect the need or desire to hedge against future crises requiring coalition war fighting. Since the end of the Cold War, coalitions have augmented U.S. military forces and lent political legitimacy to U.S. interventions in the Persian Gulf, the Balkans, and more recently, in Afghanistan. European governments are also driven by the imperative of coalition warfare, which in the future could include military operations with the United States or through the new European rapid reaction force.
- *Strengthen transatlantic relations and preserve NATO.* U.S. and European governments also pursue cooperation to support and strengthen transatlantic political relations and to sustain mutual defense commitments. This motivation was often an important driver for transatlantic defense cooperation during the Cold War. Whether the concern to sustain and strengthen U.S.-European ties will prove as strong in the future remains uncertain.
- *Encourage Europe to increase its defense investment spending.* Virtually every U.S. administration over the past several decades has used cooperative programs to encourage Europe to increase its defense investment spending in order to fulfill treaty obligations, most notably under the North Atlantic Treaty. While NATO commitments continue to be important to European governments and military planners, in the current political environment, European governments are more likely to look to cooperation with European partners to justify increases in defense spending.
- *Pool scarce resources.* The United States and Europe have a shared interest in ensuring that defense resources bring maximum benefit. The need to pool defense resources thus can provide a powerful incentive to seek cooperative solutions and is particularly appealing for smaller European countries.
- *Achieve economies of scale*. A related economic reason for U.S. and European governments to pursue transatlantic defense cooperation is the promised economies of scale that can be achieved through joint weapon systems production. Benefits can be achieved through cooperation in the development and production phases or limited to production only.
- *Increase stability of a domestic program*. U.S. and European governments may pursue cooperative programs as a means of ensuring the survival of a favored defense program. The inclusion of another country in a program can reduce the

drain on domestic resources and also make the program a less tempting target for those seeking to fund other programs.

- *Avoid potential leakage of technology to hostiles.* Governments seeking to strengthen the transatlantic defense relationship must weigh the potential benefits of cooperation against the risks that technology shared with allies might eventually leak to hostile states or subnational groups. Although technology transfers to allies generally involve acceptable risks, those responsible for safeguarding U.S. military technology and for preventing the spread of conventional arms and WMD view technology transfer, even to close allies, as a potential threat and, therefore, as something to be tightly controlled. Close transatlantic cooperation, however, may also reduce the potential risk of technology leakage as it improves each side's perception of sensitive issues and encourages adequate levels of protection.
- *Retain the ability to act unilaterally.* Defense cooperation infringes on the ability of sovereign nations to act unilaterally and entails, at least, a partial loss of control over program management and over the final product.[22] In considering whether to pursue transatlantic cooperation, governments, therefore, will consider the broader impact of cooperative efforts on the state's latitude in international affairs and its control over defense programs.

Industry-led Cooperation

Over the last decade the center of gravity in cooperative programs has shifted from government to industry, particularly in cooperative activities that focus on technology demonstration, major system development, production, and ultimately, business arrangements.[23] As U.S. companies have gained experience in working with their European counterparts, they have become increasingly active in seizing the initiative, identifying business opportunities, and seeking prospective partners. European companies, lacking either the resources or the mass needed to compete against U.S. giants, often have had little choice but to pursue cooperative opportunities. Although both U.S. and European companies have actively sought opportunities for transatlantic cooperation, the motivations driving these cooperative ventures may be different. Business decisions to either pursue or resist cooperation are driven by several factors:

- *Improve position vis-à-vis domestic competitors.* When defense companies are in serious competition for domestic or export customers, they may seek to differentiate themselves from their competitors through special teaming arrangements. European defense companies, for example, know that it is very

22. The typical government-sponsored cooperative program is managed using one or more layers of bilateral or multilateral committees. Decisions are reached either through consensus or through some voting formula. Individual governments relinquish authority over the program but retain the ability to assert their will by withholding resources (money, staff, and facilities).

23. Throughout the 1970s and 1980s, an opportunity for international cooperation typically would be brought to DOD by an allied or friendly government, or by a DOD entity, and only occasionally by industry.

difficult to win a DOD contract if they insist on being the prime contractor. Similarly, U.S. companies understand that securing business in Europe is dependent on European domestic industry serving as prime contractor or, at least, as a highly visible partner.

- *Promote new technology for domestic and export programs.* U.S.-European defense industrial partnerships are also motivated by the desire to gain access to, combine, and exploit the technology and know-how possessed by all the industrial partners. With the increasing reliance of defense companies on commercial technology, partnering will remain a powerful incentive.
- *Secure market access for exports.* The decline in U.S. and European defense expenditures since the end of the Cold War has also changed the incentives governing export sales. U.S. companies have been compelled to seek export sales as a means to sustain staff and physical infrastructure and to position themselves for future business opportunities. European defense industries confront similar pressures to expand exports—pressures that are unlikely to ease as long as the declining trend in European defense budgets is not reversed.
- *Avoid potential exploitation of technology by industrial competitors.* In contemplating a cooperative program, industry is likely to weigh carefully the potential benefits and risks of technology sharing. Despite strong disincentives and penalties, there is always the possibility of unauthorized transfers of military technology and know-how to other unauthorized commercial applications.[24]

Constraints on Cooperation

Even when both government and industry have sufficiently strong incentives to move forward with a cooperative venture, political, legal, and structural constraints can dampen the initial enthusiasm of the partners, impede ongoing progress, or even lead to failure at different stages of the project. The most important constraints on cooperation are U.S. and European government policies.

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From a government point of view, a more open transatlantic industry and technology base should be welcome, in theory, since it can enhance force interoperability in the alliance and secure greater efficiencies in defense procurement. Government policies and practices, however, are not uniformly supportive of cooperation and instead have had an ambiguous impact on the transatlantic relationship, both pro-

24. The disincentives to such transfers remain strong. Each major capital regulates the transfer of specified military equipment and technology and places restrictions on their use. Transfers are made only between trusted companies. Moreover, there are powerful commercial incentives for companies to honor nondisclosure agreements with other companies and to honor other company's intellectual property rights. Failure to abide by the conditions of transfer can lead to monetary fines, loss of export/import privileges, and imprisonment.

moting and constraining it. U.S. restrictions on foreign direct investment and foreign ownership, different anticompetition regulations in the United States and the EU, and U.S. export control policies impose serious constraints on effective transatlantic defense cooperation.

The Reality behind "Fortress Europe"

In general, the European defense market has been significantly more open to U.S. sales and technology than vice versa. There are concerns in the United States that this situation may be changing, however. The commitment to a more autonomous European security policy, combined with the consolidation of European defense industries across national borders, is said to be spilling over into European defense acquisition decisions and emerging European institutional policies with respect to the defense industrial and technology base.

Government acquisition decisions in Europe point increasingly to a "European preference." In its May 2000 decision on the Eurofighter missile, the British government, long a supporter of transatlantic cooperation, rejected the Raytheon bid, which had U.S. government support, and opted for the Meteor ramjet missile being developed by MBDA. Additionally, coincident with an announcement of the intent to lease four Boeing C-17 transport aircraft, the UK government also committed to the competing European A400M, under development by Airbus, a consortium in which BAE SYSTEMS is a 20 percent participant.[25] Despite continuing difficulties in obtaining firm German government commitment to the A400M, eight European countries have agreed to move the Airbus program forward.

Though perhaps signaling a new trend in European acquisition strategies, the Meteor and A400M decisions are consistent with a longer European history of encouraging and promoting (usually with government contracts) cross-border, European defense platforms, including the Eurofighter, the NH-90 and Tiger helicopter programs, the Horizon frigates (a French-Italian naval program), and a large number of MBDA missile programs.

The tradition of joint platform development in Europe has developed over a long period of time and has yielded what many Europeans see as their most successful joint aerospace ventures: Ariane and the family of Airbus civilian air transport planes. With declining budgets, fewer acquisition programs, and a desire to protect the current industrial and technology base, such program decisions are likely to continue in the future.

Not all joint European programs are thought to have a clear economic or strategic rationale, however. While Europeans generally view Europe's Galileo project as a civilian project with clear strategic, commercial, and economic benefits, many in the United States consider it as a competing satellite-based navigation system to the U.S.-managed Global Positioning System (GPS).

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25. Geoffrey Hoon, UK secretary of state for defence, "Transcript of Oral Statement on Defence Procurement to the House of Commons," *Hansard*, Column 149, May 16, 2000. There was a transatlantic element in the winning bid for the Meteor missile, with Boeing as a small participant on the Matra BAe Dynamics team though not with regard to actual production.

According to the prevalent U.S. view, this example in intra-European cooperation illustrates the inefficiencies that can result from related initiatives. Not only does the proposed European system create serious transatlantic complications, including possible interference with GPS and loss of interoperability, it is also perceived in the United States as a wasteful use of Europe's scarce resources.

For Europeans, on the other hand, Galileo represents a major technological advance with the potential to provide useful services in many other areas that benefit society as a whole. Unlike GPS, which was essentially designed for military use, Galileo aims at securing greater continuity and reliability of services useful to modern business, while offering the same degree of technological precision as GPS. In addition, the project is developed in such a way as to allow for complementary and interoperable use between Galileo and GPS, while rivaling most other European infrastructure projects in terms of economic viability.[26]

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Other government policies in Europe are also shaping a more distinct European defense market. For several years, national policies in some EU member states have sought to sustain and support the European defense industrial and technology base, acting at times as counterparts or competitors to U.S. defense industrial giants. Although protectionist tendencies on behalf of narrow national interests may have been a key rationale behind related policies in the past, new developments in recent years have contributed to a reorientation in thinking at an EU-wide level.

With the headline goals of the European Security and Defense Policy (ESDP) now more sharply defined, governments are looking to European industrial capabilities for the equipment that will support this capability, including air transport, sealift, precision guided-munitions, and UAVs. At the November 19, 2001, Capability Improvement Conference, the General Affairs Council agreed on a European Capability Action Plan (ECAP) for the purpose of "incorporating all the efforts, and investments, developments, and coordination measures executed or planned at both national and multinational level with a view to improving existing resources and gradually developing the capabilities necessary for the Union's activities."[27]

European governments have also begun to recognize that there is a growing need for European-level institutions and policies that will provide a context and a road map for European defense acquisition policies and defense industry behavior. A number of governments have realized that the health of a trans-European defense industrial base depends on harmonizing governments' treatment of their respective

26. An independent study completed in November 2001 by PricewaterhouseCoopers shows a benefit-cost ratio of 4:6. For the study's executive summary, see <http://www.europa.eu.int/comm/energy_transport/library/gal_exec_summ_final_report_v1_7.pdf>.

27. The work of the European capability action plan was officially launched in the ECAP opening gathering that took place in Brussels on February 11–12, 2002. Several ECAP panels reporting to the European Union Military Committee are already active.

defense industries, but the push for harmonization has yet to produce fully satisfactory results.

To promote greater harmonization of European government policies in the defense industrial area, the six largest European defense producers (Britain, France, Germany, Italy, Spain, and Sweden) signed, in 1998, a Letter of Intent (LOI) committing themselves to defining common rules and practices with regard to export controls, security of supply, the security of classified information and industrial security, defense R&D, the treatment of technical information, and the harmonization of defense requirements.

As defined in the July 2000 implementing Framework Agreement, the intent of this "LOI process" is to "create the political and legal framework necessary to facilitate industrial restructuring in order to promote a more competitive and robust European defense technological and industrial base in the global defense market and thus to contribute to the construction of a common European security and defense policy."[28] Since then, the six governments have been conducting detailed negotiations intended to lead to concrete decisions on each issue.

In addition to the LOI process, four nations—France, Germany, Italy, and the UK—in 1996 created the Joint Organization for Armaments Cooperation (known as OCCAR from its French acronym). The organization's goal is to become "the best multinational defense procurement agency" by, among other things, coordinating and promoting joint activities for the future and by improving the effectiveness of program management in terms of cost, schedule, and performance. It already manages a growing number of collaborative European programs, including the HOT/MILAN antitank missile, the ROLAND ground-to-air system, the Tiger attack helicopter, a counter-battery radar, the multi-role armored vehicle, and a future surface-to-air missile family. Most significantly for its future evolution, the organization will also manage the A400M European military transport aircraft.

In many respects, OCCAR is the prototype of a future European defense acquisition agency. Since January 2001 OCCAR has had legal status, allowing it to hire its own staff and to contract directly with the defense industry. One of the organization's key principles is to spread work share across European defense industries in accordance with its entire portfolio of programs, ending the previously common practice of negotiating work shares among participating countries project by project. In addition, OCCAR's goals include incorporating results from the LOI process into its working practices and the gradual development of common acquisition rules among the participating countries.

Over time, OCCAR membership is likely to expand, as other nations join in cooperative programs. This trend has already led to membership discussions with the Netherlands, Spain, and Belgium. Although OCCAR is not a formal part of EU structures, its board of supervisors includes the national armaments directors of

28. Preamble to the Framework Agreement between the French Republic, the Federal Republic of Germany, the Italian Republic, the Kingdom of Spain, the Kingdom of Sweden, and the United Kingdom of Great Britain and Northern Ireland concerning Measures to Facilitate the Restructuring and Operation of the European Defence Industry, signed at Farnborough, United Kingdom, July 27, 2000.

the member states, and the gradual expansion of its agenda may, in the long run, lead to closer ties, if not integration, between the two bodies.

The EU itself, however, has yet to develop institutions and policies that would support a more autonomous defense industrial and technology base. Processes such as the LOI and institutions like OCCAR operate on a multilateral basis outside the EU framework. In part, this practice follows a well-established pattern: the Rome, Maastricht, and Amsterdam treaties explicitly exclude defense industries from common European market rules.[29]

Although movement toward a transnational defense industrial policy is generally desirable, the future role of the EU in all defense matters will, in fact, be shaped by conflicting pressures. There is a strong preference among leading EU members not to bring defense issues into the EU. While the more powerful defense members are concerned that a consensus-based decisionmaking process would give smaller EU member states disproportionate weight in shaping defense industrial policy, others worry that the European Commission in Brussels might assume a greater role in defense industrial matters.

Concerns about the growing pressure for Commission involvement are not without basis. The latter has shown repeated interest in shaping a European-level defense industrial policy. In 1997, in a report to the Council of Ministers, it proposed that an active EU policy be developed to support the European defense industrial base, linked explicitly to the ESDP project. The Commission's goal was to "protect the industrial and technological defense base and promote the competitiveness of the European industry."[30]

Based on Commission jurisdiction, the Commission sought, in particular, to define common policies covering intra-community transfers, public procurement policies, and common customs arrangements—areas also touched on by the independent LOI and OCCAR processes. The Commission report also noted that a defense industrial and technology policy had clear links to broader EU policies on industry, trade, customs, regional development, competition, innovation, and research. The Commission already administers dual-use technology export controls, which gives it a point of access to the defense-related technology policy arena.

Regardless of the path chosen, a gradual trend toward the Europeanization of industrial policy, shaped in more protective ways, is perhaps inevitable, especially if closer transatlantic cooperation fails to materialize. The "internationalization" of defense companies in Europe is creating pressures for more multilateral rule making at a European level. A common security policy and joint forces will lead to demands for more Europe-oriented procurement. As the EU member states seek to preserve and protect employment in the defense industry and to stimulate a European R&D base in advanced defense technologies, there will be a tendency to protect these goals from U.S. intrusion or takeover.

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29. Article 223 of the Treaty of Rome and 296 of the Treaty of Amsterdam reserve defense industrial issues to the competence of the EU member states.

30. *Implementing European Union Strategy on Defence-related Industries*, Commission Communication to the Council, the European Parliament, the Economic and Social Committee and the Committee of the Regions, COM(97)583 Final (Brussels: December 12, 1997), Annex I, <http://europa.eu.int/comm/enterprise/defence/ defence_docs/def_comm.htm#an1>.

It will also become almost impossible for the emerging system to revert back to national-level procurement, acquisition rules, and industrial relations. With a defense policy organized around 15 members and an industrial base harmonized at six, the trend toward greater convergence and harmonization at the EU level is unmistakable.

The Europeanization of industrial policy will not happen suddenly; rather, it will emerge pragmatically on an intergovernmental basis, as new procurement decisions are required and the need for new rules and regulations appears. Over time, the trend toward incorporating these agreements and rules into the EU framework will become inevitable. It is very likely that European governments will be willing to pay a premium for defense equipment and acquire slightly less advanced technology more slowly, in order to support a more autonomous European defense industrial and technological base that underlies a more autonomous European security identity. Such an approach would cause European defense companies to lose the competitive edge required to succeed in the export market.

The counterforce in Europe will come in large part from industry, aware of the limitations imposed by flat European defense acquisition budgets and of the importance of securing access to a growing U.S. defense market. A European "pole of attraction," promoted by governments, will not eliminate the incentives for industry to look beyond Europe's borders. The attractiveness of the transatlantic option will depend significantly on the willingness of the United States to address the multiple obstacles to European penetration of the U.S. defense market.

The Reality behind "Fortress America"

Although trends in European policies toward a more secluded European defense market could entail risks in the future, in the current political climate, barriers to entry into the U.S. defense market are a more serious obstacle to a closer transatlantic defense industrial relationship. Many of the current barriers are based on longstanding U.S. government policies and views, which are especially difficult to change as they are rooted in levels of defense R&D spending that remain at least four times higher in the United States than in Europe.

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DOD has demonstrated a strong preference for buying U.S. defense technologies, which are seen as significantly more advanced than comparable European technologies. It has also displayed a concomitantly strong desire to protect U.S. defense technological leadership and carefully restrict European access to U.S. technical know-how. These preferences are reinforced by a guarded DOD approach to technology transfer and direct foreign investment by non-U.S. defense suppliers in R&D and production facilities in the United States.

Defense Department Preferences and Procedures. Certain DOD preferences, policies, and procedures constitute significant impediments to a more transparent and flexible transatlantic regime. Although defense cooperation in

NATO is recognized as important, no general U.S. review of national security strategy has been conducted in cooperation with the NATO allies in Europe. The 1993 Bottom-Up Review, for example, did not include European participation or consultation. The European allies were briefed on the 1997 review, but their views were not central to the discussion. The 2001 Quadrennial Defense Review makes virtually no mention of the capabilities of allies and coalition partners in carrying out the revised defense strategy.

This pattern of limited or nonconsultation with the Europeans reflects a general preference in DOD to build, train, and equip forces that can perform military missions autonomously, without European involvement. Often such preferences are linked to long-held prejudice and distrust toward major defense equipment suppliers, notably France but other continental allies as well. Although valid security concerns related to export controls and third-country transfers may at times militate against cooperation with these countries, entrenched bureaucratic views rather than a sober assessment of evolving realities and conditions are likely to shape U.S. policies.

Partly as a consequence, U.S. R&D, contracting, and acquisition planning are done largely without reference to European planning or potential technological contributions. To the degree that interoperability is desirable, the uniformed services would generally prefer that Europeans buy U.S. equipment, such as JSTARS, rather than design and procure European or transatlantic equipment. As a result, there has been relatively little U.S. DOD acquisition of European defense equipment (about $730 million worth in 1997) and a sharp decline in recent years in joint programs across the Atlantic.[31]

DOD also has the authority to decide on the release of technical data to other countries as part of a sale or cooperative program. The Pentagon's policy preference has been to restrict such transfers of information, causing significant tension in such cooperative programs as the Medium-range Extended Air Defense System (MEADS). Consequently, European buyers and partners become reluctant to acquire technology from the United States or to engage in cooperative projects, when they feel they cannot rely on the timely release of such technology, or when critical pieces of software are treated as "black boxes" to which they will not have access.

These DOD preferences result in a bureaucratic default position that strongly favors national programs and often kills cooperative projects. Even when there is high-level political support for cooperation, decisions to pursue a cooperative project may be either ignored or hampered by bureaucratic resistance. The problem can be even more pronounced following a shift in political administrations. Some senior U.S. defense officials may feel no obligation to honor government-to-government agreements (e.g., memorandums of understanding—MOUs) signed by their predecessors. Similar behavior occurs in Europe, but to a lesser extent.

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31. IISS, *The Military Balance, 1998–1999*, p. 273. This study notes, however, substantially greater two-way trade across the Atlantic in components and subcomponents for military hardware, estimating total two-way traffic at roughly $11 billion, with more than half flowing from Europe to the United States.

Export Controls. The U.S. export control system, erected during the Cold War, constitutes another significant U.S. barrier to a more flexible transatlantic defense industry and technology regime. Despite significant reform efforts over the past five years, the U.S export control system poses continued impediments to enhanced transatlantic defense industrial cooperation.

The U.S. export control system is administered by the Department of State, under authorities granted in the Arms Export Control Act (AECA), which makes the secretary of state responsible for the "continuous supervision and general direction of sales, leases, financing, cooperation projects and exports" of defense articles and services.[32] The State Department determines what defense articles and services are covered under this authority, which are then placed on the U.S. Munitions List. The State Department, which administers the review of more than 45,000 export license requests a year, takes a generally conservative view of the export of technologies on the munitions list to any other country, including members of the EU.

Export control rules written during the Cold War have been extended, reflecting unchanging and even growing concern within the policy bureaucracies about the risk of the loss of technological superiority and the proliferation of capabilities that could be used, one day, against the United States. This concern is mirrored in the U.S. Congress, where issues relating to defense technology exports and direct investment by European firms in the U.S. defense economy have been hotly debated.

The State Department also writes the regulations governing this list and the licensing procedure, known as the International Traffic in Arms Regulations (ITAR). Each time a U.S. firm wants to export a commodity or know-how to a non-U.S. buyer, or wishes to engage in negotiations or discussions with a potential foreign partner over an export, joint venture, merger or acquisition, the firm must hold an export license from the Office of Defense Trade Controls (ODTC).[33] The statute and ITAR also explicitly protect against the retransfer of this knowledge, product, or technology to third parties.[34]

The complexity and slow pace of the export control process and the length of the munitions list act as strong deterrents to potential European partners, who are increasingly reluctant to include U.S. parts in European programs. Disparities between U.S. and European policies and practices governing the export of dual-use items, coupled with delays in export licenses for certain U.S. parts and uncertainties about the ability to retransfer platforms containing those parts, have strengthened this European reluctance.

Although often detrimental to transatlantic defense cooperation, the policy preferences of DOD and the agency regulatory processes involving technology transfer and export controls reflect political realities in the United States. There is

32. The AECA (22 USC 2778-80) was first passed in 1968 and has since been frequently amended. The secretary's authority is contained in chapter 1, sec. 2b, "Coordination with Foreign Policy." See U.S. Senate Committee on Foreign Relations and U.S. House of Representatives Committee on Foreign Affairs, *Legislation on Foreign Relations Through 1990*, vol. 1 (Washington, D.C.: GPO, February 1991), pp. 274–347.

33. Section 39(a)(1) and 39(b)(2) of the AECA statute.

34. ITAR is found in 22CFR 120–130. The ODTC authority to designate articles is in sec. 120.4.

widespread concern about risks that U.S. technological secrets or certain defense technological leads may be lost to competitors abroad or to hostile countries, with negative consequences for U.S. national security. Doubts about the effectiveness of European export control systems are also widespread. These concerns can translate into strong resistance, especially in the U.S. Congress, which is deeply involved in arms exports, export controls, and defense investment issues.

Congress is notified of the intent to license a sale of major defense equipment or services above a certain dollar threshold. It also legislates the statutes that regulate arms traffic. Through its oversight authority, it conducts hearings on major arms trade and export control issues.[35] The role of Congress in export control matters and the political concerns of some members have been a restraint on efforts to reform U.S. processes, statues, and regulations in a direction that would bring more transparency and flexibility to the transatlantic relationship.

U.S. Reform Efforts. Despite growing concern about problems and shortcomings in the U.S. export control system, reform has proven difficult to achieve. The first Bush administration directed a review of the U.S. Munitions List with the aim of removing items that had achieved commodity status as commercial technology. The effort proceeded for about five years, but ultimately produced very little change, leaving the unfinished task of reform to the succeeding administration.

During the second Clinton administration, the Pentagon pushed hard to reform its internal processes with respect to technology transfers and export license reviews, to streamline government-wide processes, and to begin a transatlantic dialogue on these issues with the European allies. The outcome of the DOD effort was the signing of declarations of principles (DOPs) with the governments of the United Kingdom and Australia, which initiated a dialogue between these governments and the United States on the harmonization of defense trade rules, practices, and procedures.[36] At the close of the second Clinton term, the DOD intended to expand such negotiations to other countries, including the Netherlands, France, Germany, Norway, and Sweden, among others.

Despite strong internal resistance to the DOD effort, the State Department in May 2000 also moved to reform its export control procedures through the Defense Trade Security Initiative (DTSI). Most significantly, the DTSI's 17 reforms included a proposed exemption to the ITAR process for "countries that share with the United States congruent and reciprocal policies in export controls, industrial security, intelligence, law enforcement, and reciprocity in market access." As in the case of Canada, the exemption would cover only some unclassified exports. Approval of the exemption, however, would depend on establishing "appropriate international

35. Congressional concerns about exports and technology proliferation have a long history, including most recently, hearings and reports on possible Chinese industrial and military espionage in the U.S. nuclear labs and the space launch industry. See U.S. House of Representatives, *Report of the Select Committee on U.S. National Security and Military/Commercial Concerns with the People's Republic of China* (Washington, D.C.: January 3, 1999).

36. See Secretary of Defense William S. Cohen and Minister for Defence Geoffrey Hoon, Declaration of Principles for Defense Equipment and Industrial Cooperation between the Department of Defense of the United States of America and the Ministry of Defence of the United Kingdom of Great Britain and Northern Ireland (plus Annex), February 7, 2000.

agreements on end use and retransfer of defense items, services and technical data and on close conformation of essential export control principles." The United Kingdom and Australia were explicitly identified as "the two countries most ready to take advantage of this exemption."[37] In addition, the DTSI required an expedited review and streamlining of the munitions list.

Such ongoing efforts to reform the U.S. export control process will continue to face formidable obstacles. The actual negotiations over agreements that would create an ITAR exemption opportunity have been difficult, since other countries must agree to "level up" export controls, law enforcement, industrial security, and intelligence sharing.

Moreover, the U.S. Congress has resisted this reform process. Following a negative reaction to the exemption proposal, it suggested the need for legislation to prevent the granting of license-exempt status to other countries or for notification and review by the Congress before such an exemption were granted. With the terrorist attacks of September 11, 2001, resistance in Congress could continue, stalling progress on these reform efforts.

The current administration initially chose to continue negotiations with the UK and Australia on exemptions, with a view to further promote the reform agenda, and some slow progress has been noted recently.[38] The importance of interoperability and the realities of a global market for dual-use technology have not changed with the shift in administration. In a recent speech at the Farnborough air show, NATO secretary general Lord Robertson welcomed recent U.S. developments in the export control area, including the DTSI, the U.S.-British DOP, the envisaged National Security Presidential Directive for a comprehensive, six-month review of the U.S. arms export control system, and most significantly, the new Global Project Authorization introduced for the Joint Strike Fighter (see below).

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On the other hand, the longer-term impact of September 11 on the prospects for further reforms, including the formation of a transatlantic defense industrial and technology regime, remains uncertain. In theory, September 11 should rein-

37. The reforms included other changes to U.S. export controls as well that could streamline the process. They provided for a pilot program "major program license," where a single, comprehensive eight-year license would be provided for an entire project (with the U.S. firm as the prime contractor), rather than seeking a license for each transaction in that program. They also provided for a "major project license" for any major commercial sale of defense articles to NATO members, Japan, or Australia, covering all parts of a proposed export. A "global project license" would cover all exports planned under a government-to-government agreement for a cooperative project. Of importance to the transatlantic industry dialogue, the reforms would allow a single comprehensive authorization permitting companies "to exchange technical data necessary for teaming arrangements, joint ventures, mergers, acquisitions, or similar arrangements" with companies from NATO, Japan, and Australia.

38. The United States has signed bilateral DOPs with Australia, the UK, the Netherlands, Spain, and Norway. DOPs have been negotiated with Sweden, Germany, and France, but these are still found in the "national staffing" stage. DOP negotiations are also under way with Italy.

force the importance to the United States of allied political support and military interoperability. Heightened fears about future terrorist attacks, however, including the use of WMD, could exacerbate bureaucratic and congressional concerns about the risks of technology outflow. U.S. defense planners' increasing focus on asymmetrical threats also could complicate discussions about which technologies and products must be controlled to protect U.S. national security.

At the same time, however, there continues to be broad consensus that the U.S. export control system attempts to control too much in light of the widespread diffusion of technologies with defense-related applications. Advancing the export control reform debate in the post–September 11 political climate means shaping the reform agenda around the potential benefits from proposed changes—such as in the areas of R&D, military interoperability, and political cohesion.

As Lord Robertson has also noted, "no one is advocating an 'anything goes' liberalization of the U.S. Export Control Act. But there is legitimate concern that the rules are sometimes—perhaps unintentionally—applied to distort economic competitive advantages rather than protecting legitimate security concerns."[39]

Legal and Regulatory Constraints

Additional constraints on transatlantic defense cooperation are imposed by U.S. and EU restrictions and regulations governing direct foreign investment and mergers and acquisitions.[40]

U.S. Foreign Ownership Restrictions. DOD concerns about security, technology transfer, and foreign influence can impede European investment in U.S. defense firms, as well as acquisitions and mergers that are likely to grant European companies more direct access to the U.S. defense market. Although not the only voice in U.S. government decisions regarding European direct investment in the U.S. defense industry, the Pentagon's position is critical.

The broader U.S. government system for scrutinizing and approving direct foreign investments in the United States—the CFIUS (Committee on Foreign Investment in the United States) process—brings DOD together with representatives from several U.S. government agencies, including the Justice, Commerce, and State Departments and the Treasury, to review all such acquisitions.[41] The aim of the CFIUS review is to determine whether a proposed transaction will result in foreign control of U.S. assets, which control might threaten to impair U.S. national security. Although generally a CFIUS review moves quickly and the acquisition is

39. Speech at the GKN Farnborough Dinner RAC Club, London, July 25, 2002.

40. This section draws from two presentations made by William Kolasky and Stephen Preston to the CSIS Commission's experts group.

41. It also includes several offices within the Executive Office of the President. Under regulations set down in 1991, the CFIUS can receive notification of a proposed takeover from any agency or any party to the acquisition, or it may itself choose to review a transaction. Once formally notified, at least three members of the CFIUS must decide within 30 days that there should be a review of the case. Within another 45 days, the review must be conducted and a recommendation made to the president, who has another 15 days to make a decision on whether to block the transaction or allow it to go ahead.

approved, cases involving defense firms tend to have a higher profile and involve significant time and resources.

CFIUS review of a proposed transaction involves an investigation of technology transfer and other national security issues, including the impact of the transaction on the ability of domestic industry to meet national defense requirements, its effect on the availability of military goods to state sponsors of terrorism, the nature of the technology being transferred, and the security infrastructure of the acquiring company. The review also looks at the track record of the acquiring company regarding the protection of sensitive data and whether the company's national government is a U.S ally, has a record of protecting U.S technology, and has in place policies and procedures to ensure that U.S data is not conveyed to foreign entities, including foreign parents and affiliates.

Given the complexity of the CFIUS review, the mere prospect of it has served as a deterrent to some transatlantic acquisition attempts, especially in the wake of a highly politicized effort by Thomson-CSF in 1992 to acquire the defense assets of LTV Corporation.[42]

Approval of a transaction by the Departments of Justice and Defense may also include requirements related to the Foreign Corrupt Practices Act (FCPA), which regulates the operations of individuals or businesses either organized or with a principal place of business in the United States, as well as U.S. or foreign persons acting within U.S. and non-U.S. companies whose securities are publicly traded on a U.S. exchange. U.S. approval of a proposed transaction may require that an uncovered foreign entity comply with FCPA or call for structural changes that would obligate a previously uncovered entity to comply with FCPA restrictions.

Antitrust and Competition Law. In addition to security concerns, the prospect of a defense merger may also raise antitrust concerns in the United States and Europe. In a highly concentrated defense market with high barriers to entry, any proposed merger or acquisition inevitably raises questions about competition and future market conditions—both of which, in turn, affect government acquisition strategies.

In the United States, a proposed transaction will be reviewed by the Department of Justice or the Federal Trade Commission (FTC), with input from DOD. Under U.S. laws and regulations, proposed transactions are subject both to horizontal and vertical analyses to determine whether they may substantially lessen competition on the basis of price, quality, or innovation. DOD, for example, will assess the impact of a proposed transaction on competition for DOD contracts, cost savings or increases, and other factors that affect such contracts.

In contrast to reviews of civil mergers, in cases involving defense companies greater emphasis is placed on the impact of a merger on the number of viable bidders for future projects. The qualifications of potential buyers as well as the viability of divested assets come under close scrutiny during the review. If problems are identified, a variety of remedies may be sought to allow the transaction to proceed,

42. In part, as a result of the Thomson/LTV case, acquisition of U.S. defense assets by European firms has been largely restricted to British buyers, notably BAE SYSTEMS, Smiths Industries, and LucasVarity (now part of TRW).

with structural changes often required as a condition of approval in order to address concerns about competition.

Proposed transactions also must be cleared by the European Commission and, on occasion, by national authorities in individual member states. EU competition law prohibits mergers that will create or strengthen a dominant position, as a result of which "effective competition would be significantly impeded in the common market or substantial part thereof."

Under current EU law, firms are required to report proposed defense transactions that would surpass defined thresholds, followed by a Commission-led two-stage review process.[43] The review applies only to civil aspects of a defense merger, since under Article 296 of the Amsterdam Treaty member states may object to a review of any transaction that entails national security considerations. When the merger has both military and nonmilitary applications, the Commission reviews the nonmilitary aspects of the deal, while national merger laws are applied to the military ones.[44] As in the United States, remedies may be required to address competitive concerns.

…significant complications can arise from the need for various review processes by U.S., European (national), and EU authorities.

As several recent inter-European and transatlantic transactions illustrate, significant complications can arise from the need for various review processes by U.S., European (national), and EU authorities. Although all four examples listed below represent cases where the companies ultimately managed to secure the necessary legal authorizations, their success largely depended on the companies' efforts to jointly address the key competitive concerns present on either side of the Atlantic.

- *BAe/GEC Marconi.* The proposal by British Aerospace (BAe) to acquire the Marconi Electronic Systems (MES) division involved a review of the defense aspects of the merger by both the United States and the UK, since GEC Marconi, though a UK company, had substantial U.S. defense assets. A review by the U.S. authorities and the European Commission of the merger's civil aspects was

43. Member states on occasion may instruct the parties to a merger not to notify the Commission in Brussels or, alternatively, to inform the Commission that a review of the proposed defense merger by the Commission would be inappropriate. Member states must exercise some caution in making such requests, however, since improper use of Article 296 can prompt an appeal by the Commission to the European Court of Justice.

44. In practice, a proposed merger may be reviewed by one or more member states and/or by the Commission. The UK, for example, reviewed transactions involving BAe/GEC Marconi, BAE SYSTEMS/Lockheed Martin Sanders, GEC/VSEL, and BAe/VSEL. The UK and Italy both reviewed the proposed transactions involving GEC Marconi/Alenia and General Electric/Finmeccanica, while France and the UK reviewed the BAe/Lagardere transaction. Other defense dealings scrutinized in Brussels include EADS, EADS/Nortel, Northrop Grumman/Litton, INSYS/Hunting Engineering, Raytheon/Thales, Thomson/Banco, Thomson/Racal, BAE/Saab, SNECMA/Messier Dowty, and Matra BAe Dynamics/DASA. The Commission may also review proposed transactions by U.S. firms, as seen in the deals involving Allied Signal/Honeywell, Boeing/McDonnell Douglas, and GE/Honeywell. In the case of the latter, the Commission prohibited the action arguing, among other things, that the merger would create or strengthen the companies' dominant position in markets for engines for large commercial and regional jets and for avionics and nonavionics systems.

also required. UK and U.S. competitive concerns ultimately were resolved through undertakings involving the UK Ministry of Defense. The European Commission raised no competitive concerns, reasoning that the relevant markets were global, the parties' market position was not substantial, a number of significantly sized competitors existed, and that in the market for large aircraft purchasing decisions were made by Airbus, not BAe.

- *Rolls-Royce/Allison.* Rolls-Royce planned and prepared carefully for the U.S. review of its proposed acquisition of Allison Engine Company. The company acquired legal counsel with extensive experience both in CFIUS and FOCI (foreign ownership, control, or influence) issues, managing the process for acquisition approval early on, prior to the start of the 30-day CFIUS review. The company provided briefings to officials at the Departments of Defense, Commerce, State, and Treasury and to the U.S. Congress, explaining the rationale for, and potential security and industrial benefits of, the transaction. Draft documents were also circulated and amended to address U.S. governmental concerns, including the creation of a two-tier special security arrangement (SSA).
- *Thales/Racal.* Thales's acquisition of Racal in 2000 similarly involved considerable planning and preparation, especially in light of the past failed LTV acquisition attempt. Thales submitted drafts to key officials before filing with the U.S. authorities, in order to flag potential problems and avoid post-filing reviews and investigations. Communication within the company was streamlined in order to ensure rapid turnaround between the transaction team in Washington and corporate executives in Europe. Special provisions were devised to conform to U.S. security regulations and to address DOD concerns about a potential conflict of loyalties and undue foreign influence on the company's management. Thales provided a legal commitment to maintain a full proxy board and SSA and agreed informally to "level up" to the latest security standards and apply international export standards to the company as a whole.
- *Thales/Raytheon.* In mid-2001, Thales and Raytheon successfully launched a joint venture to concentrate on air defense command and control centers and ground-based radars to protect large geographic areas against air threats. The undertaking, which involves a 50-50 transatlantic joint venture company incorporated in the Irish Republic, was not without difficulties. An antitrust appraisal was undertaken both in the United States and the EU. The joint venture went forward, but only after adaptations to address U.S. regulations and the business objectives of the two partners.

As these and other cases demonstrate, cooperation between the United States and the EU has been remarkably smooth. To be sure, some differences remain. The two sides, for example, hold different views of the implications of mergers between suppliers of complementary products for competition and of the impact of vertical integration on competition and efficiency.

Such divergences of opinion were evident in cases of proposed mergers such as Boeing/McDonnell Douglas and GE/Honeywell, both of which involved substan-

tive and procedural differences. Beyond such isolated cases, however, the close consultation mechanisms that have developed between the respective authorities are evidence of the level of pragmatism and spirit of cooperation achieved on both sides. Further attempts, such as the joint U.S.-EU Merger Working Group, would contribute significantly to expanding the good progress that has been secured thus far.