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The Sword and the Marketplace: Europe Needs a Defence Union to Support its Economic Integration

Has Europe's Hamilton moment arrived?[1] Some observers have argued for a federalist revival involving the creation of a common euro area budget for economic stabilisation and convergence purposes.[2] On June 19th last, the [Meseberg Declaration](#) featured a proposal by France and Germany to establish a Euro Area budget in that spirit, starting in 2021. However, Europe remains far from any political agreement on the assumption of common debt and tax-raising capabilities, which were the defining characteristics of the role of the federal government in US economic history. Besides, economic stabilisation was not the preoccupation of the American founding fathers. Instead, military expenditures played a dominant role in the growth of the US federal budget in the early 19th century. While close to half of budget allocations went to federal debt reduction, the share of "War" and the "Navy" in regular expenditures jumped from around a quarter under Jefferson's presidency, to more than half during Madison's war[3]. In essence, the federal budget was there to pay for wars and the protection of borders in order to consolidate the very existence of a new political entity. Can lessons be drawn for Europe currently?

The European Union (EU) is facing considerable external risks and security threats on its Eastern and Southern flanks, as well as renewed pressure to ensure independently its own security. The Trump presidency and the prospect of Brexit have cast new doubts on the strength of North-Atlantic solidarity and autonomous European defence capacities. Such capacities have greatly diminished since the end of the Cold War in terms of equipment and readiness, in part because of budget constraints: at around 1.3% of GDP, annual EU defence expenditures amount to less than half of their US counterpart, have been overtaken by the Chinese defence budget, and remain some distance from reaching NATO commitments (2% of GDP by 2024), as the US president pointed out in a very controversial manner at the July NATO summit.

Meanwhile, on the economic front, there is consensus that the architecture of the European Monetary Union (EMU) remains incomplete in terms of preventing the relapse of existential threats such as the sovereign

debt crisis in 2012. The euro and federal institutions such as the ECB provide protection from the point of view of a credible and stable currency; however, when hit by large asymmetric shocks, individual euro area Member States only have limited tools at their disposal to cushion the effects on jobs and growth. Unlike in the US or Canada there is little risk sharing across European states to stabilize activity. Moreover, economic convergence between European countries, that would increase the robustness of the economic union, has also stalled, if not reversed, since the global financial crisis; financial and banking markets remain fragmented along national lines. In this context, national efforts to bolster defence capabilities could create strains given the prevalence of elevated levels of public and private debt, especially if additional expenditures end up taking place against the background of rising interest rates.

While NATO remains the cornerstone of the defence of Europe, the EU treaty provisions on the common

1. The opinions expressed in this paper are those of the authors and do not necessarily reflect the views of the institutions they belong to.

2. See Pierpaolo Barbieri and Shahin Vallée, "Europe's Hamilton Moment", *Foreign Affairs*, 26 July 2017

3. See Jacob Funk Kirkegaard and Adam Posen, "Lessons for European Integration from US history", *Peterson Institute of Economics*, January 2018

security and defence policy[4] reflect an archetypal intergovernmental approach, with little integrated features. There are historic reasons for this: when the far-reaching treaty of 1952, forming a European Defence Community (EDC) with a pan-European defence force, common budget and decision-making structures (the so called 'Pleven Plan') failed against political resistance, a consensus emerged that European integration was more easily pursued through economic means (and the creation of the common market) rather than more political integration. Yet Member States have recently shown increased willingness to move toward a "Europeanisation of defence". In 2016, France and Germany outlined a joint vision for a European defence union, while Italy also proposed a "Schengen for defence"[5], and a joint permanent military force. In his [Sorbonne speech](#) on 26th September 2017, France's president Macron called for Europe to establish "a common intervention force, a common defence budget and a common doctrine for action". In response to these calls, the European Commission has launched a [European Defence Fund](#), and published a [reflection paper](#) on the scope for a security and defence union, leading up to the formal establishment, in December 2017, of [permanent structured cooperation](#) (PESCO) by 25 Member States within the EU framework. Last June, the Meseberg Declaration highlighted security and defence ambitions even more prominently than EMU proposals, stressing the agreement between Germany and France "to progress towards a better integrated European defence". The "[European intervention initiative](#)", involving 9 Member States, including the UK, was launched on June 25.

If followed through these steps could help overcome some of the constraints European countries face in beefing up defence spending and building a strategic culture. Otherwise, they may not go much further than what little was achieved by setting up the European Defence Agency in 2004.

Meeting the challenge of ensuring an autonomous defence of Europe, not against but in support of NATO, requires a common willingness by Member States to provide concrete means by sharing its

cost both financial and in blood. In that respect, the significant cultural reluctance that remains in parts of the opinion in many Member States should not be underestimated given the history of their relationship with neighbouring countries, or a tradition of neutrality in some cases.

Yet economic considerations would support such a strategic decision. In short, if Europe cooperated more on defence it would be able to achieve greater collective security while keeping public expenditures in check and further integrating its economy, in line with its declared strategic and economic preferences.

HOW IS THE PROSPECT OF GREATER DEFENCE INTEGRATION RELATED TO EUROPEAN ECONOMIC INTEGRATION?

Notwithstanding future cooperation between the European Union and third countries, a defence union would support tighter and more resilient economic linkages within the European Union, especially where it is most needed, namely in the euro area.

First, defence and security are European public goods given the common nature of most external threats. From an economic perspective, public goods provide common benefits (such as a safe environment for the European marketplace and EU growth) that extend beyond the individual country cost/benefit analysis. A military attack on one Member State by a third country would not be without impact on other, especially neighbouring Member States. The human toll of terror attacks in recent years in has been tragic, especially in Belgium, France, Germany, Spain and the UK. They have also undermined economic confidence in Europe more broadly, although temporarily – thanks to remarkable social resilience. Furthermore, the perpetrators' have targeted Europe as a whole, while making use of the facilities offered by the free movement of people to operate across different jurisdictions. Pressure to close borders and restrict freedom of circulation can potentially increase operating costs for businesses across Europe. The common good feature of a secure and safe European marketplace by itself highlights

4. Articles 42-46 of the Treaty on European Union

5. P. Gentiloni, "EU needs a Schengen for defense", *Politico EU*, 15 September 2016

the economic importance of European cooperation against terrorism and other security threats.

Second, the modalities and extent of mutualisation of European defence capabilities raise design issues that are similar to those raised by economic policy coordination or integration. The criteria for assessing a successful defence policy are certainly more complex than those applied to monetary policy for instance. Yet, similar to the requirements for a collective economic strategy, there needs to be an agreement on purpose, on governance, and on the magnitude of the common capacity and pooled resources to finance it. In particular, because of the fiscal resources involved, common decision making over shared resources would imply the need for alignment of executive control and democratic accountability. Different democratic practices across countries in terms of the use of lethal force would make common decision making over sending troops into battle even more challenging than its financing.

Third, as a "sectoral" policy, a common European defence and security has a number of benefits that could contribute to strengthening the economic and monetary union.

EUROPE STANDS TO GAIN FROM POOLING ITS DEFENCE CAPABILITIES AND STRENGTHENING ITS DEFENCE MARKETS

Analysis of the "cost of non-Europe" in defence has rightly focused on economies of scale in the development of defence capabilities, and the scope for strengthening Europe's defence industry[6]. As highlighted by the Commission, the scattering and duplication of defence spending across the European Union provides ample scope for efficiency gains. The European Union maintains 178 different types of weapons systems, against just 30 in the US, yet investment per soldier is a quarter of the US equivalent, while around 80% of procurement is conducted on a purely national basis. In total, conservative estimates have put at around 25 billion € the annual efficiency gains achievable through European defence cooperation, against

total expenditure of 227 billion € for the European Union in 2017. If successful, the European Defence Fund should help secure such gains. Of course, the structure of the European defence market is more than a mere question of industrial organisation for efficiency purposes. Preserving a defence industrial and technological base is a strategic requirement, which requires to think through carefully how European preference would apply in procurement processes. In any case, it might help overcome national biases that still permeate these processes to date.

THE IMPACT OF DEFENCE SPENDING ON EUROPEAN ECONOMIC INTEGRATION HAS ATTRACTED LESS ATTENTION

On the supply side of the economy, the upgrading of defence technologies, the harmonisation of standards, and the creation of an integrated European defence industry including through more integrated procurement should also support growth and convergence within the European Union, and in particular the economic and monetary union. Work by the [Munich Security Conference](#) shows that Europe has a 120-140 billion \$ gap to close in terms of interconnectedness and digitalization of its military equipment, requiring investment in R&D, innovation, and training. Admittedly, the direct contribution to the private sector economy would be small initially, but over time, closing that gap would benefit technology, electronics and transport industries, all closely related to defence and security. What happens in defence could permeate across industrial and manufacturing structures. For example, the US military has had longstanding connections with Silicon Valley. The Defence Awards Research Agency (DARPA) in particular has been key in channelling funds and contracts from the Department of Defence to technology companies. The "Joint European Disruptive Initiative" (JEDI) launched on a French-German basis moves in that direction.

Besides the gains from integration in capacity development and procurement, the macroeconomic impact of defence spending can also involve

6. B. Ballester, "The Cost of Non-Europe in Common Security and Defence Policy", European Parliamentary Research Service, 2013.

stabilisation benefits. While there is a case for increased defence expenditure, the efficiency gains outlined above also imply budget savings at the national level which can provide greater fiscal space, including in economic downturns. In the case of countries subject to an excessive deficit procedure under European fiscal rules, such efficiency gains or even pooling of expenditures would have eased, everything else equal, compliance with the 3% deficit limit of the Stability and Growth Pact. Ironically, Greece provides a striking example of a country meeting its NATO spending commitments, while having been for a long time in breach of its European fiscal commitments. With more efficient European defence, the European Union would not have to choose between its stability pact and its "security pact".

On the demand side of the economy, defence spending is non-cyclical and persistent: hence it can in principle benefit local activity through the business cycle (e.g. via expenditures linked to military bases, and subcontracting to local industries). Data for the US suggest that states where the defence sector represents a very important part of the economy such as Hawaii, Virginia or Alaska, experience less growth volatility than states where the sectors are small or non-existent such as Minnesota or Michigan.

The regional economic impact of defence spending has previously been studied primarily in the context of base closures and military budget cuts after the end of the Cold War[7]. Such studies indicated that for each job in defence, up to one additional job was supported by related economic activity in the region, with several regions in Europe where defence industries represented significant shares of employment. The concern at the time was the need for policies to accompany the adjustment to decreasing defence expenditure. To the extent that there is now scope for additional European investment in defence, the concern will be to avoid wasteful competition for defence-related jobs by regional politicians, in a context where the defence industry often entertains a special relationship with governments that are their unique and somewhat captive customers.

Furthermore, the pursuit of efficiency gains would call for a consolidation of the defence industrial base on a European scale, which may run counter to calls for more evenly spread defence related employment across countries. In short, in the transition towards a new European defence model, there may be tension between stabilisation benefits and efficiency gains. This trade-off is worth bearing in mind when considering policy decisions with respect to the defence industry in the broader context of economic integration.

A European defence and security budget also raises the possibility of common resources. This prospect would stir a political debate that is often side-stepped by more technical measures. Citizens' consultation, and due democratic process take time, but are essential to form a truly informed European public opinion with respect to the costs, benefits and methods of European integration. In the short term, however, a European defence tax is probably as far-fetched politically as a European carbon tax. Rather, a European defence budget could at first be funded by pooling of national tax resources (which should be reduced by similar amounts from national budgets); in addition, a borrowing capacity could help deal with intertemporal financing needs. Such "defence bonds" would be issued in euro and should benefit from the joint and several guarantee of Member States participating in the European defence union. Defence bonds could thereby contribute over time to the development of a "safe" European asset – as safety would indeed characterize both its purpose and financing modalities.

To be sure, the primary objective of a European defence union is strategic rather than economic, and views among Member States still differ on the shape this strategy should take. Some are focused on the protection of European borders, while others highlight the need for greater development engagement in Africa. Sharing a strategic vision is an essential prerequisite. Moreover, defence cooperation (such as PESCO) extends beyond the EMU 19 countries -- or even the European Union for that matter, if only for the UK. Brexit will not necessarily result in diminished

7. D. Braddon, "The Regional Impact of Defense Expenditure", *Handbook of Defense Economics*, Vol. 1, 1995

military cooperation between the UK and the European Union, although the scope for defence industrial cooperation will depend on the nature of the broader future economic relationship that remains to be determined[8]. Yet, after Brexit the European Union will comprise 70% of euro area countries, with a commitment by all others (except Denmark) to adopt the single currency in the future, so that the distinction between the two becomes less material. It is therefore all the more necessary to design the European defence union in a way that will maximize its economic synergies.

European political and economic integration can only move forward if there is agreement on the diagnosis of the missing pieces, and common ground for mutual benefits. In recent years, critical situations have often triggered big changes, such as the institution of permanent

mechanisms for financial crisis management and for banking supervision.

From an EMU perspective defence and security could provide such common ground via the joint financing of European public goods, but also as an accelerator for economic integration. This would argue for making the European defence union a priority. Yet, because it will require overcoming national industrial policy considerations, regional lobbying for military jobs, and reluctance over common financing instruments, it may well be feasible only as part of a broader action plan to strengthen the European economic union.

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8. S. Besch, I. Bond, and C. Mortera-Martinez, "Plugging in the British – Completing the circuit", Center for European Reform, June 2018