



## DEFENSE INDUSTRIAL POLICY IN FRANCE: IDEAS FOR REFORM\*

The State-Industry relation in the defence sector in France has experienced a decade of deep transformation. Defence-related activities evolved from a mainly State-owned and strongly verticalized industry (very well described by Jean-Paul Hébert as an "*administered mode of regulation*") to a largely private production, characterized today by a clear walkout of the French defence procurement agency DGA from industrial and technological activities.

This national transformation happened along with the rise of the "Europe of defence." This Europeanization process was initially characterized by a multiplication of co-operation programs between countries (1980s) as well as between companies (1990s), and was accompanied by a consolidation of the industrial base. It was amplified in 2004 with the creation of the European Defence Agency (EDA).

Following this major phase of evolution, the principles of what the defence industrial policy should be today in France need some strong rethinking. The organization between the State and the Industry must be adapted to the major changes described above. The time is right to do so, as France arrives at the end of a 5-year Military Planning Act (2003-2008) and the main candidates for the 2007 presidential election have all underlined the need for a new Defence White Paper to adapt the armed forces, their doctrine and their equipment to today's context and constraints.

What could be the main features of the French defence industrial policy? At the end of a cycle of thematic conferences started in 2006, the Defence Committee of the *Fondation Concorde* met several political leaders, including Gérard Longuet, former Minister of Industry and Senator of Meuse; Jean-Pierre Masseret, former Secretary of State for Veterans and Senator of Moselle; and Hervé Morin, then MP (Eure) and currently Defence Minister (since May 2007). Their assertions and conclusions clarified, reinforced or balanced some of our own analyses and conclusions.

Three major challenges emerged during these meetings – because of their utmost importance, for the State as well as the Industry, and because of their structuring character:

- 1 - Setting up an efficient defence industrial policy
- 2 – Radically reconsidering the industry regulation framework
- 3 – Furthering the construction of the "Europe of Defence" with pragmatism

These issues are developed in the following pages. They will drive the work of the Commission in the forthcoming months.

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\* Defence Committee of the *Fondation Concorde*. Renaud Bellais, chairman; Alexis Breton, general secretary.

## I - Setting up an efficient defence industrial policy

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A defence policy has two dimensions: targets and means. It will not be possible to (re-)define France's defence policy without, in the first step, rebuilding our strategic analysis i.e. defining the missions entrusted to the armed forces – which are then described through objectives, formats and budgets.

The whole French political community agrees on the need for a new Defence White Paper. However the efficiency of our defence also supposes to reconsider how the defence industrial policy is to be managed. Today's approach remains very close to the practices of the 1980s, even if it has undergone transformations to a (limited) extent. This is the reason why France does not really have a true industrial policy. The current approach is quite coherent with an administered industry, but simply does not fit a largely private industry and does not come out as efficient.

Improving the efficiency of the industrial policy requires a global reorganization of the relationship between the State and manufacturers – reconsidering the methods and tools of regulation as well as clarifying contractual relations in the interest of all stakeholders: armed forces, corporations and taxpayers. In other words it is required to clarify the situation by giving each stakeholder the job in which he is the most efficient and by making the rules more readable.

This is very important for SMEs, which must have access to the markets and the subcontracting bids of large groups to guarantee their development and (sometimes, unfortunately) their survival. SMEs are all the more essential for large groups that the latter concentrate their activities on integrating systems and rely on SMEs, more reactive or more specialized, to provide the critical components for the production of defence systems.

Such a clarification would open the way for a modernization of the methods used by the State to ensure the equipment of forces and the related missions. This is particularly the case for outsourcing.<sup>1</sup> There are many potential sources of savings: let's be pragmatic and assess specifically the British experience on public-private partnerships without ideological blinkers.

Change is also needed to sustain the defence industrial and technological base (DITB). Today's difficulty for European companies (by comparison with their American counterparts) is that their economic model and their development are hampered by the fragmentation of markets in Europe and by an increased dependence on exports.

If competition is necessary to avoid delays and cost overruns in programs, the defence industrial policy however must elaborate the long-term partnership between the State and the shareholders of defence companies through a balanced relationship. The challenge is thus to find the adequate approaches for such partnership to succeed.

On the supply side, by guaranteeing a sufficient growth rate and level of profitability, the State could give companies the visibility that they require on the armed forces' requirements in equipment and thus better manage the DITB. This would also make it easier to find stable shareholders for the defence industry, able to place defence at the heart of their growth strategy.

On the demand side the State must preserve (or develop) its skills of "smart buyer" to narrow today's stronger and stronger asymmetry of information in favour of the manufacturers, especially since the defence industry becomes increasingly concentrated. It is the very condition to continue to defend taxpayers' interests and to have a constructive partnership with the industry.

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<sup>1</sup> See in particular the information report of Marc Francina, MP, on the "outsourcing perspectives for the Ministry of Defence" (January 2007): <http://www.assemblee-nationale.fr/12/rap-info/i3591.asp>

The State must thus have the means to conceptualize the armed forces' requirements and understand manufacturers' proposals (in their budgetary and industrial aspects), but also play a true role as the "regulator" of the defence industry. The French defence procurement agency, DGA, should not become a simple procurement agency, as this is the case now for the British DPA<sup>2</sup>, but must keep its ability to analyze the stakes and coordinate the French defence industrial policy.

Finally, if the defence industry is now private and managed as such, it cannot be considered and regulated by the State as any other industry. The very "specific" relationship between the State and the defence companies derives from the very business they have together: there is no use in trying to suppress it. On the contrary, efforts should focus on finding the suitable methods enabling decision-makers to avoid the drifts or mistakes as well as the risks of losing critical and/or strategic parts of the DITB in France (or even in Europe).

## **II – Radically reconsidering the industry regulation framework**

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It is critical to avoid a too strong disconnection between the strategy of defence companies and the interests of the Nation. The example of BAE Systems underlines that a company only directed by considerations of financial profitability, which does not fully take in consideration the interests of its "home" country, can put in danger its strategic autonomy in the long term while deciding to drop unique capabilities that it owns in the field of defence.<sup>3</sup>

The sustainability of defence competencies is important: the "quest for dividends" or financial criteria should not diminish the capacity of technological and industrial investment in order to preserve the capabilities essential to the strategic autonomy of France. Preserving such autonomy implies that the State sets up the ad hoc incentives, which would give each stakeholder of the defence ecosystem the relevant benefit.

Contractual pragmatism is therefore essential in the choices of the defence industrial policy: on one side, companies must have visibility and a given level of profitability; on the other, the State must be given guarantees on its access to defence capabilities.

The issue of the control over defence companies is thornier.

Some consider that a participation of the State in their capital is possible, but the problem is that the State is unlikely to be truly impartial. It is indeed difficult to be at the same time shareholder, customer and regulator – the risk being not to be successful in any of these functions because of the lack of clear distribution of roles and of acquisition of the required skills. There are deep risks of governance failure which, in the long run, can lead to a decline of these corporations instead of ensuring their industrial and financial sustainability.

Others suggest a control system of strategic companies via cross-investments of large groups to lock their capital. This represents a second "false good idea," because to function efficiently such a system requires a genuine and very constraining convergence of interests and strategy between the defence companies and their core shareholders.

In fact, the so-called "strong core shareholding structure", initiated by Prime Minister Edouard Balladur in the early 1990s, is not adapted anymore since today some core shareholders do not place anymore defence at the heart of their growth strategy. Because of this disconnection in strategy, some shareholders are no longer interested in the development of the companies in which they have substantial stakes and influence. This is a strong limitation

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<sup>2</sup> Defence Procurement Agency

<sup>3</sup> A former British State-owned company (British Aerospace) today completely privatized, BAE Systems has recently threatened to leave the United Kingdom and remove strategic industrial activities if the British Ministry of Defence were not able to guarantee a minimum level of profitability of its contracts.

to the growth of defence companies because it prevents them from getting the adequate funding for their long-term plans, and penalizes their governance.

A third, more radical solution seems to be the most suitable response to these institutional and economic changes: giving up the locking of companies' shareholding structure. Instead of the current "core shareholders," it would be preferable to have an opening of the capital which leads to a strong dilution of the shareholding, then reducing the influence of the main shareholders.

This solution would also create the initial conditions to go deeper in the national and, above all, European restructuring in sectors which still have to achieve or even undergo the necessary reorganizations (land systems, naval systems). Indeed the more mergers and acquisitions are based on financial and strategic interests (as opposed to "industrial meccanos" organized by the State), the more the restructuring is likely to be built on industrial dynamics favourable to the sustainability and competitiveness of the DITB.

The end of the direct shareholding of the State or of its interference in the management of companies should not at all, of course, mean the end of any regulation in this strategic industry. Indirect modes of regulation exist and/or must be imperatively implemented:

- By supervising companies' strategy through the public procurement process, the long-term programming of defence investment playing a key part here;
- Through specific legal provisions giving the State some means of control over key activities (similar to the American legislation on the defence sector<sup>4</sup>), which would make it possible to combine, for example, a non-European shareholding in a defence group and the safeguarding of the interests of the Nation;
- Through a set of rules which would ensure that governance policies and practices in defence companies are stable and open, with the industrial rationale prevailing.

### **III - Furthering the construction of the "Europe of Defence" with pragmatism**

Europe becomes a more and more critical dimension for defence industrial policy: France cannot expect to achieve its military and industrial ambitions alone anymore. The challenge can be summarized by one question: does Europe want to exist as a major player in international relations? Do we want to keep our freedom of analysis and decision by maintaining our strategic autonomy?

This is a question of political will, and as of today, nothing indicates that it exists. Political decision-makers in Europe display extreme cautiousness, preferring to get sheltered under the protective wing of NATO and the United States rather than investing on their side to guarantee their autonomy. The political will in favour of a reinforcement of the "Europe of Defence" is thus quite limited.

The Atlantic Alliance is a major asset and France must fully play its role within NATO. However being under the umbrella of NATO is not sufficient. There is no reason for the United States not to decide one day to withdraw from Europe... Investing at a sufficient level in our defence together, at the EU level, is the only condition to give Europe the means of its own protection as well as make the European Union a credible partner for the United States within NATO.

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<sup>4</sup> The United States has set up strong regulatory means of control on mergers and acquisitions in defence (protection of strategic activities) and can impose governance rules for defence-related activities: American-only directors and managers, or a strict separation between defence and commercial activities thanks to "Chinese walls" (e.g. the agreement on *Bell Labs* before the Alcatel-Lucent Technologies merger).

If there are many obstacles towards the "Europe of Defence," many French decision-makers aspire to deepen it by adopting a pragmatic approach. This could be possible especially if France shows its willingness to launch proposals and its ability to federate the expectations of its European partners through new projects or programmes.

For instance, the "juste retour" mechanism is a genuine problem. It has hampered the credibility of cooperation programs for ages. But this can change: cooperation programs can be economically efficient when they are built on the basis of economic rationality and favour technological excellence by the creation of excellence poles at the European level. It is necessary to succeed in combining industrial efficiency and the preservation of sovereignty by promoting the good practices developed through programs like the Scalp/Stormshadow missile system or the A400M transport aircraft.

The European Defence Agency, designed as the catalyst for new programs, still remains in a large extent an empty shell due to the lack of political will. Abandoning it would nevertheless result in giving up a major tool for the construction of the Europe of Defence. On the contrary, it is crucial to provide it with the means to consolidate its position and become a true factor of integration.

France has always been the engine of the building of a European defence industry. It must initiate proposals towards its European partners to reinforce actions of the European Defence Agency. It is especially necessary to prepare the future together, for a better use of public funds and a higher efficiency of our defence spending, based on strong policy decisions of the European Defence Agency. This can be carried out through the gathering of European budgets for joint R&D efforts, which would suppose to include a dedicated budget line at the level of the European Union.

Pragmatism must prevail here too. It is very unlikely that the Europe of Defence can be built immediately with all the 27 EDA Member States, but more certainly through a joint action of few determined countries. Only the main arms-producing countries are truly interested and ready to share the financial and political burden of joint projects; and they will not be able to accept that "small" countries get the same weight in the decision-making process (principle of consistency).

This is an additional reason for France to continue playing the role of the driving force in the construction of the Europe of Defence. By launching initiatives, it is capable to federate the large arms-producing countries and, eventually, induce the other countries to join already-launched projects on the basis of adequate contribution. It is the only efficient approach – the only one that makes it possible not to have to build an almost unreachable consensus with the EU members not supportive or opposed to the Europe of Defence.

Thus the Europe of Defence should be built in a balanced way between demand and supply. It is indeed equally important that companies too contribute to the Europeanization of the defence policy and do not limit themselves to wait for the States to move and answer RFPs. By launching ideas and proposals, defence companies can favour the Europeanization of our defence effort.

The Europe of Defence must walk on two legs by combining States' initiatives and industrial proposals.

## SEVEN WAYS FORWARD

- Explore all possible ways to reform the defence procurement policy so as to optimize expenditures.
- Give the DGA the vision, missions and means required to fully play the function of regulator of a now private defence industry.
- Clarify the role of each category of stakeholders in the defence business to improve the efficiency of the defence industrial and technological base.
- Define the basic rules for a partnership between the State and the manufacturers to favour a true convergence of interests between all stakeholders.
- Redefine the shareholding structure of defence companies to clarify their governance and facilitate the restructuring needed to preserve the strategic autonomy of France and Europe.
- Deepen the construction of the "Europe of Defence" as the second pillar of NATO as well as the guarantor of the independence of analysis, decision and action of France and the European Union.
- Give defence companies the means and possibility of pushing forward the "Europe of Defence" through industrial projects rather than waiting for hypothetical decisions of governments.