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Defence Procurement and the European Defence Equipment Market: the Virtues of Kissing the Frog

2015 no 4
1. Introduction

In the European Union (EU), the procurement of defence and security equipment, services and works is regulated by a specific directive (Directive 2009/81/EU) and can also be subject of a number of exemptions from EU law in general, in particular Art.346 of the Treaty on the Functioning of the European Union (TFEU), which allows an EU member State to take the measures it considers necessary for the protection of its essential security interests connected with the production of or trade in arms, munitions and war material, as long as those measures do not adversely affect the common market regarding products not intended for specifically military purposes. Even though those legal provisions have been analysed extensively in recent literature, it is also important to replace defence procurement in the EU in its historical, military, political, economic and industrial context. Indeed, the production and trade in defence equipment is closely related to the sovereignty of the State, and is often used as a tool of...
political and economic influence, both outside and inside a State’s borders. It is because of the perceived specificities of defence and security procurement that a separate legislative instrument was deemed necessary to regulate it.

This article therefore aims to assess, through a critical contextual analysis, the specificities of defence procurement. This study starts with an introduction to the changes that the end of the Cold War imposed on the European military, as an understanding of these evolutions is fundamental to comprehend current trends. Our analysis then continues with a discussion of the specificities of the European defence equipment market and of defence procurement itself. As such, this article constitutes a good introduction to defence procurement for those unfamiliar with it, and provides a useful contextualisation for those already involved with the subject.

2. Changes since the End of the Cold War

The end of the Cold War saw the nature of military operations to be performed by Western forces evolve radically. Whilst the European armed forces facing the Iron Curtain were primarily tasked, equipped and trained for territorial defence against a Soviet invasion, most military missions of European forces now consist of peace enforcement and peacekeeping operations related to regional conflicts, ethnic struggles and civil wars, and almost always take place abroad. These types of operation require different type of defence equipment than those required to

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fight a major war of invasion: the need for heavily armoured vehicles is much reduced (a main battle tank is very effective in open terrain but does not fit in the narrow streets of a Malian town), and the need for air transport capacity, for air-transportable material, for protection of the troops to limit the amount of casualties, and for weapon that can minimise collateral damage increases.\(^8\)

Such operations also usually require higher funding than training for territorial defence,\(^9\) and are much more difficult to plan than were those of the Cold War, as they could take place at any time and almost anywhere, and are subject to very different technical and operational requirements.\(^10\) In addition, those new types of military operations are usually conducted by combined forces from different States acting within the scope of a coalition or alliance. This requires more interoperable equipment, both operationally (e.g. the ability of the troops of different countries to communicate and operate together) and technically (e.g. the ability of the technicians from one country to repair the equipment of another country).\(^11\)

The end of the Cold War also led the EU Member States to reduce their defence budget in line with the poetic-economic (but maybe overly optimistic) notion of ‘peace dividends’.\(^12\) This reduction of defence budgets especially led to a decline in investments for the modernisation of the armed forces,\(^13\) despite the capability gap between the equipment of the European forces and that required for the new type of operations. This in turn required keeping existing equipment in service

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9 Flournoy, Smith et al., European Defense Integration, p. 35.


longer than what they were designed for, leading to increases in maintenance and support costs as the equipment become older.14 In addition, meanwhile, the costs of advanced weapon systems have steadily increased over time.15 During and after the Cold War, the unit production cost of advanced military equipment increased in average by 5 to 10% per year. This trend continues despite the increasing use of commercial off-the-shelf equipment in military systems.16

So on the one hand European States would need to invest in the new equipment required for the new types of military operations required by the changed geopolitical context whilst the cost of this equipment is steadily rising, but on the other hand they have to do this with drastically reduced defence budgets. European States have therefore to devise ways to review resources allocation and to 'spend smarter'.17

3. European Defence Equipment Market Characteristics

3.1 Monopsony

The first characteristic of a defence market is that of a monopsony.18 Monopsony is a market form with only one buyer, in this case the State, and potentially a high number of sellers. It is an instance of imperfect competition, symmetrical to the case of a monopoly, in which there is only one seller, but many buyers.19 Like monopoly, monopsony results in an inefficient allocation of resources.20

In domestic defence equipment markets, monopsony is evident. The State, on its territory, holds a ‘monopoly on the legitimate use of physical force’, and this is especially true as far as arms, munitions and war material are concerned. The State can therefore unilaterally affect the defence equipment market on its territory by imposing its military requirements, schedule and specifications on defence equipment suppliers. The State’s monopsony power is also strengthened by its regulatory power related to trade in arms on its territory and by the fact that defence procurement is generally managed centrally within each State.

In addition, closed national defence markets, initially caused by a desire for independence and security of supply requirements (discussed below), create a fragmentation in demand at the European level that is mirrored by an industrial fragmentation that we will discuss in the section below.

One could argue that this monopsony power exists only within a domestic defence equipment market and can only be preserved as long as domestic markets remain closed. If the European defence equipment market was fully open, there would be as many buyers of defence equipment as there are EU Member States. However, only six EU Member States (France, Germany, Italy, Spain, Sweden and the United Kingdom) represent 90% of the EU defence industrial capability, 85% of its defence spending, and 98% of its R&D spending. An open European defence equipment market would therefore still be some form of oligopsony, a market form in which the number of buyers is small while the number of sellers could be large.

However, the monopsony or oligopsony of the European defence market is tempered, in some sectors such as aerospace, by the fact that mergers and the disappearance or withdrawal of some companies from the defence market led to only a small number of major sellers remaining on the market. Therefore, in those sectors, even though the European States would benefit from oligopsony power, the latter would be mitigated by the defence industry having a counterbalancing oligopoly power. Unfortunately, such situation could also lead to

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the creation of a cosy relationship between the State and its national industry in a renaissance of the ‘military-industrial complex’, where the public interest becomes a second priority after the mutual maximisation of institutional power and commercial profit.

3.2 Industrial Structure

A second characteristic of the European defence equipment market is its industrial fragmentation.\(^{28}\) It is a consequence of the closed domestic defence equipment markets of many European countries and of the use of offsets, discussed below, which led to duplication of resources between the industries of each EU Member State, but also to monopolistic situations in some sectors of the defence industry within some Member States. Most people agree that improved cross-border competition could bring about economies of scale and reduce the costs of defence equipment.\(^{29}\) This is especially important because of the drastic reductions in defence budgets that followed the Cold War.

In addition, the lack of funding for investments in new equipment led the European defence industry to scale down their activities substantially.\(^{30}\) Because of reductions in orders and the lack of new European programmes, some companies were forced out of the business of defence equipment,\(^{31}\) and small European arms producers have now become more and more dependent on arms exports, for which they have to compete with the US defence industry without the benefit of protectionist measures.\(^{32}\)

Up to now, the inevitable restructuring of the European defence industry following the end of the Cold War mostly focussed on the liquidation of some


\(^{30}\) Communication from the Commission: ‘The Challenges Facing the European Defence-Related Industry’, COM(96)10, §1: employment in the defence-related industry was reduced by about 37.5% (from 1.6 million to 1 million, 600,000 of which work on development and production of defence equipment and 400,000 for supplier and services industry) between 1984 and 1996.


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defence-oriented capacity by some companies and on mergers that nevertheless remained mostly limited within the boundaries of each EU Member States, often because of restrictive laws or practices concerning foreign ownership of defence companies. Therefore, the fragmentation of the European defence industrial base was not significantly reduced and its competitiveness compared to the North American defence industry actually diminished. Some progress has been seen in the last years, especially in the aerospace and missile sectors, but other sectors remain fragmented. Even though the defence sector was often seen as an opportunity for creating jobs in-country, the economic rationalisation of the European defence industry let to redundancies: between 1984 and 1995, 37% of the jobs in the European defence industry were lost.

In addition to being fragmented, the European defence equipment market (EDEM) is also highly concentrated, as the European arms-producing countries do not form a homogenous group. From an industrial point of view, only those EU Member States could domestically develop a new weapon system. The industrial landscape between European States is therefore very different, which makes necessary that any detailed measures to rationalise the European defence industry be tailored to the actual industrial conditions.

Finally, when arguing for more consolidation of the European defence industry, one should keep in mind that too much consolidation could lead to the creation of monopolistic positions in some sectors, as has been the case in the

34 Communication from the Commission: ‘The Challenges Facing the European Defence-Related Industry’, COM(96)10, §2.1.2; see also Schmitt, From Cooperation to Integration, pp. 11 et seq.; Cornu, ‘Fortress Europe – real or virtual?’, in Schmitt, Between cooperation and competition, pp. 65 et seq.
37 Vlachos, Safeguarding European Competitiveness, §2.1; M. Lorell, Multinational Development of Large Aircraft: The European Experience, Paper R-2596 (RAND, 1980), p. 71; Georgopoulos, European Defence Procurement Integration, §1.5.1; Flournoy, Smith et al., European Defense Integration, p. 73.
38 Communication from the Commission to the Council, the European Parliament, the Economic and Social Committee and the Committee of the Regions: Implementing European Union Strategy on Defence-Related Industry, COM(97)538, 14 December 1997, p. 4; see also Schmitt, From Cooperation to Integration, p. 13, showing reductions in workforce between 1990 and 1995 ranging from 57% in Germany to 21% in France; Georgopoulos, European Defence Procurement Integration, p. 61.
US, and is already the case in some sectors in Europe as well. Consolidation of European defence industries therefore has to be managed carefully, and measures have to be taken to avoid the negative effects of monopolistic positions. For that purpose, a coherent European defence industrial strategy that would support integration at the European level whilst maintaining competition and be actively supported by the EU Member States would be required.

3.3 Demand-Driven Market

Another characteristic of the defence equipment market, at least for major equipment, is that it is almost solely ‘demand-driven’ and not ‘supply-driven’, contrary to most commercial markets. The defence industry usually does not develop and produce major weapons systems of its own initiative to offer them ready to buy on the market: the initiative is usually taken by the State, which drafts requirements based on its defence policy and military doctrine and then requests the defence industry to develop and produce equipment that meets this requirement. This characteristic is facilitated by the monopsonistic nature of the defence equipment market, but both are not the same. A monopsonist could for instance wait for the industry to propose equipment that could potentially meet its needs. This is usually not the case in the defence market.

On the one hand, for the defence industry, this characteristic has the advantage of reducing the economic risk of launching a new project. Investments for commercial projects are usually funded by the industry on the basis of a market analysis for the new product, taking into account the risk of not recovering the investment if the product is not as successful as expected. Conversely, the State usually pays for the investments necessary for a military programme, even though the contractor may agree to finance part of such investments with its own funds. This makes the defence industry less susceptible to market pressure, which can in turn stifle innovation and remove incentives for increased cost-effectiveness.

On the other hand, this means that the defence industry has only a limited influence on the defence equipment market and has to wait for the State to come

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forward with a requirement, even though it can exert some informal influence. With the declines in defence budgets, European States were less and less capable of driving the market in this way, and this led a number of defence industries to increasingly turn to the civil market,\(^{43}\) which in turn induced an increase in the number of dual-use goods that can have both military and civilian applications.\(^{44}\)

A specific way the European defence industry has found to maintain its technological knowledge and financial flow is to propose technology demonstrator programmes: States would fund the development and test of prototypes that would not necessarily enter into production, but would be ready to be produced would the need arise.\(^{45}\) This allows developing new systems without having to commit for production, but also starting production more quickly if the system is required at a later stage.

4. Specific Procurement Requirements

4.1 Security of Supply\(^ {46}\)

Security of supply is one of the key requirements of defence procurement, and has been defined as a guarantee of supply of goods and services sufficient for a Member State to discharge its defence and security commitments in accordance with its foreign and security policy requirements.\(^ {47}\) It therefore aims to ensure the continuing supply of defence materiel and/or services to the armed forces, without regard to external circumstances such as war, international unrest, shifts in alliances, and disruption of the supply chain.\(^ {48}\) However, the concept of security of supply actually covers different aspects of equal importance to the defence supply chain:

- The stability and durability of the supply chain over the life of military equipment, which can be up to 50 years (‘longer-term’, or ‘strategic’ security of supply);
- The ability of the supply chain to supply the armed forces in various theatres

\(^{43}\) Georgopoulos, European Defence Procurement Integration, p. 34.


\(^{46}\) This section is substantially inspired by Heuninckx, ‘Security of Supply and Offsets in Defence Procurement’.


of operations that could be far from the home country and the location of which is increasingly difficult to predict in advance, and wherever the supplier itself is located (the geographical aspect of ‘operational’ security of supply);

− The ability of the supply chain to cope with ‘surges’ (unplanned increases) in requirements during operations that can have to be initiated at unexpected times (the time aspect of ‘operational’ security of supply, or ‘short-term’ security of supply).

The easiest way, but most disrupting of market efficiency, to accommodate security of supply has often been to award defence contracts only to domestic companies or to require offsets (discussed below) to build or consolidate the defence industry on national soil. Domestic companies can provide goods and services to the armed forces without crossing borders (as long as the troops are not deployed abroad), and are therefore less susceptible to international embargoes or other disruptions. Moreover, domestic companies can be more efficiently controlled by the State, and can therefore be expected to give sufficient priority to the national armed forces’ requirements over time.

However, even though awarding contracts to domestic companies could resolve the issues of ‘strategic’ security of supply, ensuring long-term continuity of the supply chain, it does not necessarily result in an effective supply to the troops in the field if the domestic companies do not establish an expeditionary supply chain exhibiting significant synergies with the military forces. ‘Operational’ security of supply can be ensured, for instance, by including specific ‘sleeping clauses’ in contracts or by ‘deferred contracts’ that the contracting authority can activate in case of a crisis to require preferential changes in prioritisation of supply or urgent increases in requirements, and by ensuring that the contractor maintains a worldwide ‘militarised’ supply chain, but such measures are not related to offsets or to the nationality of the contractor.

Moreover, because of the substantial changes of the geopolitical situation of Europe since the end of the Cold War and with the increasing integration of the EU, the concept of security of supply within Europe would require re-evaluation.


especially taking into account the reduced defence budgets of the European States. There are now fewer grounds to claim that security of supply cannot be enforced with a contractor from another EU Member State. It is questionable if preserving a domestic defence industry is currently economically and politically feasible for small and medium-sized EU Member States.

However, there remain geostrategic and legal obstacles to the security of supply of the EU Member States’ armed forces. External embargoes against some EU Member States are still possible (see for instance the delicate geopolitical situation of Cyprus or of the Baltic states). Even within the EU, the continuing existence of exemptions from EU law on the free movement of goods and services, such as the Art.346 TFEU exemption, can be used by EU Member States as a tool to hinder the supply of war material to fellow EU Member States. Indeed, even though that exemption is most often used by EU Member States to protect their domestic defence industry in order to attain some security of supply, it can also be used to justify retaliatory measures against another EU Member States, for instance the denial of an export license for military equipment that is to be used in a military operation not supported by the exporting State. As long as such exemption can be used in this way, there will be justifications to use it to protect one’s domestic defence industry in the name of security of supply, even within the EU.

Nevertheless, short-sighted enforcement of security of supply is one of the most likely causes of the current European defence equipment market fragmentation. Security of supply is also used as a convenient excuse to support the domestic industry for social or political reasons.

Directive 2009/81/EU includes specific provisions allowing the EU Member States to take security of supply into account in the qualitative selection of the candidates and in the award of contracts, either as contract performance conditions or as award criteria. In addition, the Directive acknowledges that, if the security of supply requirements of the contracting authority are so extremely demanding that even the specific provisions of the Directive are not sufficient to

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safeguard Member States’ essential security interests, an exemption from compliance from EU law, such as Art. 346 TFEU, could still be invoked.56

4.2 Urgency

As mentioned above, operations since the end of the Cold War are more and more difficult to plan in advance in terms of timing, location and duration. As the reduced defence budgets do not permit the States to afford stocking large quantities of equipment that can perform all possible missions in all possible circumstances at any time, measures have to be taken to allow States to cope rapidly with surges in demand, but also with unexpected operational requirements, such as countering new threats (for instance the new types of improvised explosive devices invented in Afghanistan) or operating in specific terrains that were not envisioned when the equipment was initially procured.

This characteristic is one of the causes of the requirement for security of supply, and sometimes leads the military to keep some maintenance or development capability in-house or in-country to be able to meet these surges in requirements,57 even though it might not be cost-effective from a purely economic point of view.

Directive 2006/91/EC allows the use of the negotiated procedure without publication when the minimum time-limits for the restricted procedure and negotiated procedure with publication of a contract notice are incompatible with the urgency resulting from a crisis such as a peacekeeping operation or a terrorist attack,58 for instance when additional supplies or services are needed to cope with such crisis.59

4.3 Security of Information

It is quite obvious that the characteristics and specifications of defence equipment should not be made available to potential enemies. Even militias or terrorist groups are now perfectly capable of understanding the weaknesses of military equipment and use them to their advantage. States are therefore often reluctant to show transparency in their defence budgets for fear that this might be an indication of their operational priorities, and impose restrictions on their procurement activities, for instance in the choice of their suppliers. Moreover, this secrecy also applies to the defence industry, not only because it has to protect

57 As stated in a number of places in the United Kingdom Defence White Paper – Defence Industrial Strategy.
58 Directive 2009/81/EC, Art. 28(1)(c) and Recital 53–54.
59 Directive 2009/81/EC, Art. 23(d).
the classified requirements used to develop equipment, but also because, the international defence equipment market being highly competitive, the defence industry wants to protect the results of its research and development, even though the latter is obviously not specific to the defence industry.

Secrecy can occasionally be used to attempt to avoid showing accountability in defence expenditures. Moreover, security of information requirements are sometimes used as an excuse to award contracts by negotiated procedure without publication solely to domestic companies, or to make authorisation for trading in military equipment subject to the condition that the responsible managers of the businesses concerned must hold the nationality of the authorising State. However, these uses have been found disproportionate by the Court of Justice of the EU.

Directive 2009/81/EU therefore contains specific provisions aiming at protecting classified information for defence and security contracts.

4.4 Specific Technical Requirements

As mentioned above, military forces and their equipment are now required to be highly mobile and flexible, and to operate in varied geographical situations against widely different types of threats. Military operations have to be performed under any climatic conditions, from arctic to deserts, in dust, sand or ice. This, on the one hand, requires military equipment to comply with varied and demanding environmental requirements and, on the other hand, induces wear and damages that are not usually encountered by civilian-type equipment or on the European continent. As a result, high-end modern military equipment becomes more and more technologically complex, which is one of the reasons for its high price.

Military equipment also has to comply with specific technical requirements that are usually not found in the civil market, such as survivability (the ability to avoid detection and, if detected, to withstand damages and still complete the mission), night operations, or the use of systems for specifically military appli-

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61 Commission v. Italy (Agusta Helicopters) (Case C-337/05) [2008] ECR I-2173, paras 50–54, discussed in B. Heuninckx, ‘A Note on Case Commission v Italy (Case C-337/05) (Agusta Helicopters Case)’ (2008) 17 PPLR NA187; Schiebel Aircraft v Bundesminister für Wirtschaft, Familie und Jugend (Case C-474/12), judgment of 4 September 2014, not yet reported, para 39.
63 Vlachos, *Safeguarding European Competitiveness*, §2.4.
cations such as guns and the related ammunitions, electronic counter-measures, or cryptographic communications. The need to avoid collateral damage requires the use of precision-guided munitions and of advanced intelligence-gathering equipment such as infrared cameras and satellites. The unwillingness of the Western population to accept casualties among their own armed forces also drives requirements for increased protection (body armours, protected vehicles) and for the use of standoff weapons.

Even though the procurement of some civilian products or services involves a similar level of complexity, the combination of complexity and specificity mentioned above is typical of defence equipment.\(^6\) For major weapon systems, this leads to very long development cycles and makes extremely difficult to define technical specifications from the outset. Open or restricted competitive procedures are therefore found by most not to be entirely adequate for the procurement of complex military equipment.\(^6\) For this reason, Directive 2009/81/EU allows the use of the negotiated procedure with publication for the award of all defence and security public contracts.\(^6\)

### 4.5 Interoperability and Standardisation

We saw that, because the new operations following the end of the Cold War are usually performed within coalitions and appliances, interoperability of the equipment has become paramount requirement. One of the ways to ensure interoperability is the standardisation of defence equipment, whereby the armed forces of different States use the same equipment, even though interoperability does not necessarily require the use of the same systems as long as the equipment used by each State participating in the coalition is able to conduct operations with the others.\(^6\) Such standardisation also has the potential to reduce development and support costs because of economies of scale.\(^6\) In its proposals to define a co-ordinated EU defence equipment policy aiming to create a genuine European defence equipment market, the European Commission therefore urged for the standardisation of defence equipment across EU Member States.\(^7\)

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\(^6\) Georgopoulos, *European Defence Procurement Integration*, p. 28.
\(^6\) Directive 2009/81/EC, Art.25 and Recital 47.
\(^7\) Communication from the Commission: ‘European defence – industrial and market issues’, §3.
Defence Procurement contracts often include offset requirements, whereby the purchasing country requires the contractor to ensure some form of return on investment on its national territory that may sometimes exceed 100% of the value of the contract. Such offsets may be ‘direct’, in the form of orders or transfers of know-how and technology related to the subject matter of the original contract to local companies (such as licensed production of the equipment being procured). Conversely, ‘indirect’ offsets are unrelated to the subject matter of the contract in question and can benefit other industrial sectors, even non-military ones. ‘Semi-direct’ offsets are similar to direct offsets, but for equipment that is to be delivered to the contractor’s country or to a third country instead of to the purchasing country (for instance where the licensed production chain also produces the equipment destined for the armed forces of another country). A number of different classifications of offsets have been proposed, and the types of offsets are only limited by the imagination of the parties concerned.

We saw that the primary means to ensure strategic security of supply has often been to procure defence equipment from domestic companies. However, in the case of major weapon systems, this is only possible for arms-producing countries whose industry is able to design and produce a broad range of complex military equipment, such as France, Germany, Italy, Spain, Sweden or the United Kingdom. This option is not available at a reasonable price for smaller countries. Offsets can be a solution in these cases, as licensed production, for instance, requires much less industrial capacity and know-how than the development of...
an entirely new weapon system, whilst still ensuring the existence of a domestic industrial base to support the national armed forces.

By definition, offsets constitute discrimination on the ground of nationality (in breach of Art.18 TFEU), and are contrary to the free movements of goods provisions of the EU Treaties as measures having equivalent effect as quantitative restrictions on import and exports (in breach of Art.34 and 35 TFEU), and to the freedom to provide services provisions of the Treaties (in breach of Art.56 to 62 TFEU). Offsets are therefore contrary to EU law, and may only be used if an exemption from applicability of EU law applies, in particular one of those related to national security, such as Art.346 TFEU.78 This means that offsets have to be justified case-by-case based on the need to protect stated essential national security interests79 and cannot be used to promote aims of a purely economic nature.80 Even when offsets would be suitable to ensure the protection of the security interests concerned (such as the security of supply of the armed forces), they could only be justified if such protection could not have been addressed through less restrictive measures.81 The use of offsets, as for other measures that can only be justified on the basis of EU law exemptions, may never go beyond what is appropriate and necessary to protect the security interests concerned.82

As mentioned above, one could argue that ensuring security of supply solely at the national level could be found to be a questionable policy in the current geopolitical situation of Europe,83 and is probably becoming unaffordable. This conclusion obviously applies to the use of offsets. In the light of the advances of European integration, requiring offsets for European defence procurement becomes more and more difficult to justify on this ground. However, the continuing existence of possible external embargoes and of the use of the Art.346 TFEU exemption to hinder intra-EU trade in defence goods renders the picture of a potentially integrated European market for defence goods more complex.

81 Insinööritoimisto InTiimi (Case C-615/10), judgment of 7 June 2012, not yet reported, [45]; Schiebel Aircraft (Case C-474/12), paras 34 and 38.
82 Johnston (Case 222/84), para 38; Schiebel Aircraft (Case C-474/12), para 37.
In addition, offsets can also be a convenient excuse for developing or sustaining the domestic industry mainly for social or political reasons, but – in addition to being likely unjustifiable on the basis of EU law – this is usually achieved at the expense of cost-effectiveness. The political use of offsets leads to work allocation on the basis of factors that do not necessarily seek to achieve the most efficient technological and economic solution. This often creates additional development work and duplications of industrial capacity, especially in case of licensed production (multiple assembly lines for the same equipment) or of mandatory substitution of some original parts of the weapon system by parts produced and/or designed locally.

Indeed, offsets can have the consequence of increasing the procurement costs of military equipment by as much as 30%. The reasons for such increases are probably a combination of: shorter production runs, duplicate investments, higher manufacturing costs in the receiving country, higher sales price from the contractor in order to compensate for lost work, or licence fees that can amount to 10% of the sales price. However, assessing the global economic impact of offsets is difficult, and should not be limited to the price paid for the weapon system being procured. Nevertheless, it seems that the actual impact of offsets in terms of job creation or diversion, technology transfer, and increased international competitiveness of the domestic industry is, despite the large sums involved, much smaller than expected.

Moreover, although direct offsets can be a way to ensure ‘strategic’ security of supply through the survival or growth of the domestic defence industry, security of supply can only be ensured at the weapon system level if offsets are not limited to some parts or subsystems of the weapon system. Requiring the substitution of some original parts of major military equipment by parts produced or designed locally would only ensure security of supply for those parts, not for the whole system. Therefore, only the types of offsets most disruptive of the supply chain, such as licensed production, can really ensure some security of supply at the weapon system level.

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85 Georgopoulos, European Defence Procurement Integration, footnote 705; In some cases, such as the procurement of the US armoured personnel carriers M113A and AIFV by European countries, for which offset arrangements required licensed production in Europe, cost increases reached up to 100% because of offsets: W. Struys, ‘Offsets and Weapons Procurement: The Belgium Experience’, in Martin, The Economics of Offsets, p. 99; in Japan, it was estimated that for some systems the cost increase was up to 55–80%, even though others argued that 10-25% savings were being made: M. W. Chinworth and R. Matthews, ‘Defence Industrialisation Though Offsets: The Case of Japan’, in Martin, The Economics of Offsets, pp. 203–204; Antonakis, ‘Offset Benefits in Greek Defence Procurement Policy’, p. 167.

In addition, when offsets are indirect and benefit non-military equipment or the civil sector, they constitute a distortion of the EU internal market for civilian goods and cannot be said to contribute to security of supply for military equipment, thereby being very difficult to justify on national security grounds. Indeed, measures taken outside of the scope of EU internal market law on the basis of Art.346 TFEU may not affect competition in the market for products not intended for specifically military purposes.

5. Conclusions

In some fairytales, ‘happily ever after’ comes from kissing the frog. The trick is that kissing frogs is repulsive to most people, and the moral of the story is therefore that only those brave enough can attain the prized reward.

Only a few actors of the European defence equipment market have kissed the frog yet.

Since the end of the Cold War, Western States are confronted with more complex military operations that require new and more sophisticated equipment that is more expensive than before, but in the meantime have drastically reduced their defence budget in the hope of reaping the ‘peace dividends’. States have therefore to spend smarter, which is not necessarily an easy task.

At the same time, a general consensus seemed to emerge that the European defence equipment market, on the buyer’s side and on the industry side, had to evolve because of changed operational and political context, reduced budgets, industrial over-capacity, duplication between domestic industries, lack of standardisation and dependence from the United States. However, the European defence equipment market is still very much in a misshapen state. Because of the reduction of demand from European States, it has evolved into a difficult relationship between cash-strapped buyers in an oligopsony position that are hardly able to drive the market as they did earlier, and a defence industry finding itself caught between an uneasy survival as a cluster of protected entities fragmented along national lines and an evolution into an oligopoly at the European level.

Therefore, defence procurement practice should evolve to spend smarter and support the evolution of the market. This would require drastic measures, such as opening-up domestic defence markets to competition, increasing collaborative procurement efforts between EU Member States, and implementing a coherent European defence industrial strategy that would support integration

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at the European level whilst maintaining competition. Security of supply and secrecy requirements, which are still used by some EU Member States to attempt to ensure the survival of their domestic defence industry, should be rationalised and the priority set to seek efficiency at the European level.

European States have to make some hard decisions. To find the prince charming of cost-effective defence procurement, one has to kiss the frog of fundamental reforms.