

PART XIII
DEFENSE PROCUREMENT

DEFENSE PROCUREMENT REFORM IN THE EU, FROM AN ITALIAN PERSPECTIVE

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ABSTRACT. The reform of Defence Procurement inside the EU stems from the assumption that competition as well as a set of harmonized procurement rules could improve market efficiency and therefore would protect or even promote innovation. In the last few years, starting from the Green Paper on Defense Procurement up to the promulgation of a diversified set of measures the European Commission aimed to promote the gradual creation of a European defence equipment market (EDEM) with enhanced transparency, accountability and competition, whilst respecting the sector's specific nature. Moving towards a truly European market has been recognized as crucial for strengthening the competitiveness of European defence industry, improving the allocation of defence resources and supporting the development of the Union's military capabilities under the Common Security and Defence Policy (CSDP). Moreover a more integrated defence market would allow greater cross border cooperation and thus larger economies of scale as well as increased industrial competition, with subsequent savings.

Defence markets have particular characteristics because of the very nature of military products and related services. Defence industries are therefore of a strategic nature and have special relations with the state. As sole clients, states determine demand for products on the basis of military needs linked to their strategic objectives and thus define the size of the market. The special nature of the defence sector has been recognised ever since the establishment of the Community through an exemption system laid down in Article 296 EC of the Treaty (now article 346 TFEU).

In recent years public debate has underlined the positive effect of competition on promoting industrial innovation as well as on lowering the costs for tax payers, due to greater economies of scale of an enlarged market. The majority of Defence related goods are customized, i.e. are tailored to fit the procurer specific and often unique needs. The procurer then hires a contractor who supplies the goods according to a set of desired specifications. The academics call this the procurement

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problem. Such problem is also present in the defence market, albeit in different form. While it is true that in Europe sole source national award decisions are seldom challenged in court by competitors from other EU nations, revealing a quasi-tacit industrial understanding on the sharing of the market, the same is not true in the US, where the Department of Defence always seeks and is able to accomplish formal competition for major system procurement.

What if the way ahead lies both in stronger cooperation within Europe, combined with the implementation of a real transatlantic market? Providing a tentative answer to this question lies within the scope of this paper.

To this end the financial crisis may pose a risk as well as offer an opportunity for the European defence sector: on the one hand, it sounds plausible that shrinking budgets increase the pressure on Member States to cooperate and thus overcome the EU's problems related to restructuring of the defence industries and markets. On the other hand, national prerogatives still dominate despite a decade of initiatives for more cooperation and less state in EU defence.

The decline of domestic demand, has increased the need to boost exports in order to ensure that production lines operate at full capacity and thus remain competitive in unit prices via "economies of scale". Hence, the shrinking of markets has led to their globalization. This tendency is likely to continue as long as investments in the domestic markets do not increase significantly.

One possible answer could be increasing the cross border competition, including across the Atlantic: in other words increasing the competition within the cross border cooperation.

Yet it is worth noting that the historically open European defense market may be in the process of closing substantially, as part of the "Europeanization" of overall defense policies and defense industrial policies, in particular. The emerging European industrial and technology base will be protected from the United States. European governments may still be willing to pay a premium for defense equipment, and acquire slightly less advanced technology, more slowly, in order to support this base.

INTRODUCTION

The European Union has consistently updated in the past decade the rules concerning procurement procedures for public works contracts, public supply contracts and public service contracts. This trend, based on the fundamental principles of the internal market - i.e. simplification, harmonization and modernization - recently targeted also the Defence Procurement Market.

The reform of Defence Procurement inside the EU stems from the assumption that competition as well as a set of harmonized procurement rules could improve market efficiency and therefore would protect or even promote innovation. On this basis, a reflection on how to optimize Defence procurement at national and EU levels started within the EU, with the end goal of having a single set of rules for procuring Defence equipment in Europe.

Cost efficiency of Defence spending, the maintenance of a competitive Defence and technological industrial base, better access for EU manufactured goods to third markets, ethics and fairness in the arms trade, security of supply, and also the need to respect Member States prerogatives in this sensitive area are all important considerations when defining an EU armaments policy.

Moving towards a truly European market has been recognized as crucial for strengthening the competitiveness of European defence industry, improving the allocation of defence resources and supporting the development of the Union's military capabilities under the Common Security and Defence Policy (CSDP). Moreover a more integrated defence market would allow greater cross border cooperation and thus larger economies of scale as well as increased industrial competition, with subsequent savings.

The particular characteristics of defence markets are not only economic and technological, but are mainly related to the security and defence policies of each Member State. As sole clients, States play a dominant role in defining the market. They control the arms trade by means of export licences and the granting of authorisations to tender for contracts. In addition, security of supply and confidentiality requirements in the defence sector often lead to the use of purely national procedures. Finally, arms development programmes are complex due, in particular, to their

limited production volumes, high risk of commercial failure, and the length of their life cycles.

The financial crisis has certainly boosted negotiations and initiatives for more international cooperation and a complex framework of overlapping cooperation clusters currently unfolds.

What if the way ahead lies both in stronger cooperation within Europe, combined with the implementation of a real transatlantic market? There are significant and growing obstacles to achieving a more open and flexible transatlantic regime for defense industrial and technological cooperation. Most of these obstacles are the result of government policies: the EU member states are committed to protect employment in the defense industry and move to stimulate a European R&D technology base in advanced defense technologies. Two tendencies may appear: first, European level institutions will be increasingly tasked with regulatory responsibilities for this activity; second, this emerging European industrial and technology base will be protected from the United States. European governments may be willing to pay a premium for defense equipment, and acquire slightly less advanced technology, more slowly, in order to support this base. But the impact of financial crisis might change it all.

THE ROOTS OF THE REFORM

With roughly 20 to 30 % of governmental procurement being represented by defence equipment, and in a time of crunching governmental funding the European Commission and by EU Member States devised what is called the “defence package” (Interpretative Communication of the Commission on article 346, Defense Procurement Directive and Intra Community Transfer Directive); in the last few years, starting from the green paper on Defense Procurement up to the promulgation of this diversified set of measures the Commission’s aim was to contribute to the gradual creation of a European defence equipment market (EDEM) with enhanced transparency, accountability and competition, whilst respecting the sector’s specific nature.

The opening up of defence markets, fragmented along national lines, has the potential of increasing the commercial opportunities for European companies in the sector, including SMEs, and contributing to their growth and increase their competitiveness.

Yet to create an EDEM a set of complementary initiatives was required, including the establishment of an appropriate regulatory framework for the procurement of defence equipment.

THE CHARACTERISTICS OF THE DEFENSE MARKET

The Green Paper[†] was the first measure set up by the Commission to investigate the reasons hindering the growing of a more competitive EDEM. It opened an official consultation process lasting four months from 23 September 2004 onwards. The purpose of the Green Paper was to develop the debate on these issues, bearing in mind the principle of subsidiarity[‡]. For this purpose the Commission set up two working parties consisting of representatives of the Member States and European industry to contribute to the preparatory stages of the Green Paper.

The results of the Green Paper consultation emphasized three characteristics of these markets:

- the major fragmentation of markets along national lines;
- the specific features which distinguish them from other types of public procurement;
- a complex legal framework.

Although Member States' combined military expenditure is considerable, it remains split into national markets. This fragmentation poses a major problem for all Member States with defence industries. Following budgetary reductions and the restructuring of the armed forces, the size of national markets – including those of the large states – is no longer sufficient to allow for production volumes that can offset the high R&D costs of arms

[†] COM(2004) 608

http://europa.eu/legislation_summaries/internal_market/businesses/public_procurement/

[‡] Work of the Council Working Party on Armaments Policy (POLARM), the Western European Armaments Group (WEAG), and the *Agency Establishment Team* responsible for establishing the European Defence Agency.

systems. This situation, along with the fragmentation of R&D spending in Europe, increases the cost to the taxpayer and damages both the competitiveness of the European defence industry and its ability to meet the requirements of the CSDP. Given the growing dual use potential of technologies (military and civilian), the global competitiveness of European industry is also affected.

Some progress has been made in the last ten years, particularly as a result of the increase in European armaments cooperation and an initial opening-up of national markets to European competition with regards to cooperative programmes, but the still frequent use of the principle of fair return on investment (“juste retour”) generally limits any opening-up to the participating countries and implies a distribution of work based on purely national industrial policy criteria. As for national procurement, the share of contracts awarded by competitive procedure is still low and, irrespective of the procedures used, national suppliers are still generally awarded most of the contracts.

Defence markets have particular characteristics because of the very nature of military products and related services[§]. Defence industries are therefore of a strategic nature and have special relations with the state.

Following privatizations and efforts to optimise procurement policies in recent years, the role of the state has been reduced, but it still remains dominant. As sole clients, states determine demand for products on the basis of military needs linked to their strategic objectives and thus define the size of the market. They participate, to varying degrees depending on the country, in the financing of R&D, thus influencing the technological know-how and long-term competitiveness of industry. As regulators, they control the arms trade by means of the licences which exporters must have, including for the delivery of equipment within the European Union, and the granting of authorisations to tender for contracts. State control also extends to industrial restructuring, although to a more limited degree, and even to the level of shareholding.

[§] See the document of the POLARM Working Party of the Council, annexed to communication COM(1997) 583 of 4.12.1997.

The nature of defence requires sources of supply to be guaranteed for the entire duration of an arms programme from the time the equipment is designed until it is withdrawn from service, at times of peace and at times of war. States may, therefore, see fit to set up special supply guarantees. The maintenance of a purely national industrial capacity for defence may seem a reliable way of being able to respond to strategic interests and emergency situations (military operations).

The nature of defence may also require states to have equipment that guarantees the technological superiority of their military forces. This superiority depends, in particular, on the confidentiality of programmes and their technical specifications. The obligation to protect this confidential information means companies must have special national security clearances.

Another common feature of arms development programmes is complexity. Since production volumes are limited and the risk of commercial failure high, state support is required. Equipment often consists of new systems which incorporate both military and civilian technologies. It has also a long life cycle: the time between the expression of an operational need and the end of a system's life may be as long as 50 years. The quality/price ratio and risk management must be guaranteed throughout this period. States must, therefore, have access to adequate industrial and technological capacity throughout the life cycle of a system and maintain lasting, reliable relations with suppliers.

In addition to this, "off-the-shelf**" arms purchases were often subject to offset arrangements. This allowed the purchasing country to require a return on investment that may exceed 100% of the value of the contract. Such offsets may be direct, in the form of orders for local companies or transfers of know-how and technology related to the original contract. Offsets may also be indirect and concern industrial sectors other than the one covered by the contract in question, even non-military ones.

THE LEGAL FRAMEWORK

The special nature of the defence sector has been recognised ever since the establishment of the Community through an

** Finished equipment already developed and available for purchase.

exemption system laid down in Article 296 EC of the Treaty (now article 346 TFEU). According to paragraph 1 of that Article:

“(a) no Member State shall be obliged to supply information the disclosure of which it considers contrary to the essential interests of its security;

(b) any Member State may take such measures as it considers necessary for the protection of the essential interests of its security which are connected with the production of or trade in arms, munitions and war material; such measures shall not adversely affect the conditions of competition in the common market regarding products which are not intended for specifically military purposes.”^{††}

Given its wide scope, this article may also apply to public procurement.

Consequently, Community rules apply in principle to the defence sector, but Member States may derogate from them in the circumstances and subject to the conditions set out in the Treaty. In any event, the possibility of a derogation provided for under Article 346 TFEU cannot apply either to civilian goods or to those not intended for specific military purposes, even if they are purchased by national defence ministries.

The Case Law of the Court has interpreted the conditions of use of this derogation restrictively^{††}.

As a general rule, Member States may, therefore, derogate from the rules of the Treaty and Community directives, but only in well defined circumstances. Nevertheless, several difficulties of implementation arise:

in the absence of a precise interpretation of these provisions, there is quasi-systematic use of the derogation in the area of public procurement.

Since the concept of essential interests of security is not defined either in Community Law or in the Case Law of the Court of

^{††} In accordance with paragraph 2 of this Article, a list of products to which the provisions of paragraph 1 apply was adopted by the Council in 1958.

^{††} See among others: Johnston judgment, Case 222/84, Commission v. Spain judgment, Case C-414/97. Although the latter concerned VAT, it is applicable to public procurement.

Justice, in practice States allow themselves wide discretion in determining which contracts could have an impact on their security interests.

The list drawn up in 1958^{ss} is not an appropriate reference for defining the scope of Article 296 EC, since it has never been officially published or revised since then.

For defence procurement most national legislation provides, or provided before the Directive 2009/81/EC for exemptions to the application of public procurement rules, with differing degrees of transparency. This constitutes a potential difficulty for non-national suppliers.

The publication of contract notice, if happens at all, is in special national publications, the content, frequency and method of dissemination of which vary from state to state, and the potential for non-publication provided for in national legislation is vast, and differs depending on the country. The criteria for selecting suppliers take into account, if not the ability of offering industrial offsets – or at least not officially - for most states, confidentiality and security of supply, the definition of which remain vague and the assessment of which does abide to the same requirements. Technical specifications are often very detailed - sometimes referring to the origin of the product or the nationality of the supplier - and based on widely differing standards.

Tendering is mainly through negotiated procedures which do not all follow the same rules, particularly as regards the extent of the negotiations and the possibilities for changing the subject of the contract. Besides, although in the award of contracts priority is given to best value for money, in some States security of supply and offsets are still again taken into account.

As highlighted by Gian Luigi Albano, Nicola Dimitri, Isabelle Perrigne and Gustavo Piga^{***} “participation in tendering processes is a crucial dimension of procurement. A commonly accepted view is that a large pool of suppliers has to be attracted in order to obtain economically advantageous conditions. The main intuitive reason is that, in most circumstances, a large number of participants induces tough competition which, in turn,

^{ss} See Footnote 6.

^{***} “Fostering participation”, Handbook of Procurement, Cambridge University Press 2006, pp. 267-292

translates into high savings and attractive standards of quality. Suppliers, however, differ in various respects: market shares, access to the credit market, and information on the nature of the procurement contract are just a few dimensions of heterogeneity among them. Thus, if large participation may be *per se* a desirable feature of a procurement tendering process, the final outcome will eventually be affected by the individual characteristics of participants. If only a few large suppliers participate it is likely that they will attempt to reach a tacit agreement to soften price-quality competition. If, instead, the pool of potential suppliers includes a large number of big and small firms, then anti-competitive behaviour becomes more difficult to sustain. The buyer then faces a double task: attracting a large number of participants and affecting the pool of suppliers in order to stimulate the participation of the most efficient ones in the market.”

THE EU DIRECTIVE 2009/81

The above considerations relating to defence procurement show a number of obstacles limiting the access of European industries to Member States’ defence markets and hence restrict their growth opportunities. As a result, under the strong resolve of the Commission, Member States found the consensus necessary to issue the Directive 2009/81: Member States agreed on the need to foster, develop and sustain a European Defence Technological and Industrial Base that is capability driven, competent and competitive

Yet some exclusions still apply: in the fields of defence and security, some contracts are so sensitive that it would be inappropriate to apply the Directive, despite its specificity. That is the case for procurements provided by intelligence services, or procurements for all types of intelligence activities, including counter-intelligence activities, as defined by Member States. It is also the case for other particularly sensitive purchases which require an extremely high level of confidentiality, such as, for example, certain purchases intended for border protection or combating terrorism or organised crime, purchases related to encryption or purchases intended specifically for covert activities or other equally sensitive activities carried out by police and security forces.

The Directive itself states that none of the provisions posted should prevent the imposition or application of any measures considered necessary to safeguard interests recognised as legitimate by the Treaty. This means in particular that the award of contracts which fall within the field of application of the 2009/81 Directive can be exempted from the latter where this is justified on grounds of public security or necessary for the protection of essential security interests of a Member State.

This can be the case for contracts which necessitate such extremely demanding security of supply requirements or which are so confidential and/or important for national sovereignty that even the specific provisions of the Directive are not sufficient to safeguard Member States' essential security interests, the definition of which is the sole responsibility of Member States. Nevertheless, in accordance with the case-law of the Court of Justice of the European Communities, the possibility of recourse to such exceptions should be interpreted in such a way that their effects do not extend beyond that which is strictly necessary for the protection of the legitimate interests that those Articles help to safeguard.

This exclusion means also that in the specific context of defence and security markets, Member States retain the power to decide whether or not their contracting authority/entity may allow economic operators from third countries to participate in contract award procedures.

The Directive does not apply either to contracts awarded by international organisations for their purposes or to contracts which must be awarded by a Member State in accordance with rules that are specific to such organisations as well as to international agreements or arrangements between Member States and third countries apply, as for example relating to the stationing of troops.

THE DEFENSE PROCUREMENT REFORM IN ITALY

Italy dealt with this scenario, finally enforcing legislation and regulation at the beginning of 2012: in this process the key player in Italy is the General Secretariat / National Armament Directorate, who has prepared the transposition law for the Defense Procurement Directive and is responsible for the invocation of article 346.

Before the Directive 2009/81/EC, Defence procurement in Italy was mainly based on the general rules stated in decree n.163 (04/12/2006), that's to say the Italian Code of Public Contracts containing the fundamental regulations on public procurement. Such a code basically includes:

- principles and procedures for public procurement, mainly deriving from the transposition of the directives 2004/17/EC and 2004/18/EC;
- rules on the relevant legal disputes;
- principles and procedures for those contracts whose value is lower than the minimum threshold set in the above EU procurement directives, as they are out of the relevant field of application.

Yet, taking into account the peculiarity of Defence requirements, the "Code" itself already contained a specific reference to a separate regulation to be implemented in the Defense field.

As stated above, the efforts to overcome the structural problems of procurement in the Defense and security fields and the need of a strong and competitive EU Defense equipment market have finally brought to the prescriptions of Directive 2009/81/EC. This directive has been transposed into the Italian legal system with the Decree n.208 (11/15/2011), that entered into force on 15th of January 2012.

What now happens is that the bulk of Defense procurement falls in the field of application of Directive 2009/81; nevertheless, in some cases, Italian MoD still applies the rules deriving from Directives 2004/18 and 2004/17, transposed into the Italian "Code of Public Contracts". Therefore, although improved, the legal framework in Italy remains fragmented.

Many rules of directive 2009/81 are substantially those of Directive 2004/18, hence during the lengthy transposition phase of the European Directive 2009/81 the Italian General Secretariat of Defense had to face the challenges of simplify on the one hand, and harmonize, on the other hand, the whole set of national rules on Defense procurement, in order to avoid any overlapping or gap. The transposition work was based on two basic choices:

- the rules laid down by directive 2009/81 were all included in a new decree, that thus set out the rules referred to the

peculiar aspects pertaining to the Defence and Security fields;

- for all the remaining procurement prescriptions, the General Secretariat of Defence made explicit references to the Italian “Code on Public Contracts”.

According to this, among other things, in the new decree Italy took into account the contents of both articles on Security of Information and of on Security of Supply.

As for the award procedures, Italy chose to exclude the use of open competition, enabling the choice of both restricted and negotiated procedure with publication of the contract notice, regardless of specific circumstances.

The innovation to the general rules of the Directive is in reference to sub suppliers: in fact, Italy introduced the possibility of proposing subcontracting not only to the initiative of the tenderer, but also in the hands of the contracting authority.

THE CONOMIC DEBATE

In recent years public debate has underlined the positive effect of competition on promoting industrial innovation as well as on lowering the costs for tax payers, due to greater economies of scale of an enlarged market, therefore economists have contributed to designing new auction markets for activities ranging from the sale of spectrum licenses for mobile operators to that of electricity supply contracts. However, within the “ordinary” (not defence related) market the extent to which these auctions can deliver the intended results crucially depends on many factors, mainly:

1. how concentrated the target market is;
2. how bidders respond to strategic incentives.

In a recent paper Timothy G. Conley and Francesco Decarolis⁺⁺⁺, document that average bid auctions (ABA) give strong incentives to bidders to coordinate their entry and bidding choices. However, the results also indicate that it is not obvious that bidder cooperation should always be sanctioned. Indeed, they present

⁺⁺⁺ Detecting Bidders Groups in Collusive Auctions, November 18, 2011, University of Wisconsin - Madison (<http://www.ssc.wisc.edu/~fdc/>)

the case of a relevant market in which bidder cooperation reduces the procurement cost for the auctioneer. Hence, the results argue against any automatism in antitrust activity. Therefore, the study joins the recent literature on market design in arguing in favor of a careful design of incentive schemes in auctions and procurement mechanisms.

Klemperer^{†††}, from a very different perspective, argues that some details of auction-market rules may facilitate coordinated effects (and explicit collusion), in particular through creating the standard checklist conditions of market transparency, high frequency of firms' interactions, and difficult entry, but often discussions on 'bidding markets' often confuse details of the price formation process (whether or not there is an auction or bidding system) with deeper structural features of the market. Similar competition problems arise in auction markets as in 'ordinary' economic markets, and for similar reasons. It is commonly accepted that bidders with fewer competitors bid less aggressively, and even if they bid equally aggressively, the winning bid among fewer bidders is on average less aggressive.

The majority of Defence related goods are customized, i.e. are tailored to fit the procurer specific and often unique needs. The procurer then hires a contractor who supplies the goods according to a set of desired specifications. The academics call this the procurement problem^{§§§}. Such problem is also present in the defence market, albeit in different form. While it is true that in Europe sole source national award decisions are seldom challenged in court by competitors from other EU nations, revealing a quasi-tacit industrial understanding on the sharing of the market, the same is not true in the US, where the Department of Defence always seeks and is able to accomplish formal competition for major system procurement. It is true that the US industrial base is capable of providing a number of competitors high enough to ensure effective competition, nonetheless the US industrial base has been interested in time by a process of mergers and acquisitions that has reduced the number of players.

^{†††} Paul Klemperer, "Bidding Markets", UK Competition Commission paper, June 2005

^{§§§} Patrick Bajari and Steven Tadelis "Incentives and award procedures: competitive tendering vs. negotiations in procurement" - Handbook of Procurement, Cambridge University Press 2006, pp. 121-140

THE IMPACT OF FINANCIAL CRISIS

The financial crisis may pose a risk as well as offer an opportunity for the European defence sector: on the one hand, it sounds plausible that shrinking budgets increase the pressure on Member States to cooperate and thus overcome the EU's problems related to restructuring of the defence industries and markets. On the other hand, national prerogatives still dominate despite a decade of initiatives for more cooperation and less state in EU defence. Art 346 and the principle of *juste retour* kept the armaments sector a purely intergovernmental business. Its structure is hence characterized by the obstructing diversity of EU member states approaches to policy of defence, market, technology and industry

The Commission strongly reminded Member States that they should take the decision whether to award contracts under the Directive 2009/81 on grounds of value for money, recognizing the need for a globally competitive European Defence Technological and Industrial Base, the importance of open and fair markets and the obtaining of mutual benefits. Member States should press for increasingly open markets. Their partners should also demonstrate openness, on the basis of internationally-agreed rules, in particular as concerns open and fair competition.

European States often conduct cooperative programmes to develop new defence equipment together. Such programmes are particularly important because they help to develop new technologies and bear the high research and development costs of complex weapon systems. Some of these programmes are managed by international organisations, namely OCCAR and NATO (via specific agencies), which then award contracts on behalf of Member States. For example, the transnational agency OCCAR**** was set up in 1996 and given legal personality in 2000. Its contractual rules are more competition-based and provide for replacing the system of a "*juste retour*" per programme by an

**** "Organisation conjointe de coopération en matière d'armement" i.e. Joint Organisation for Armaments Cooperation; open - subject to certain conditions - to all the Member States; at present only five states belong to it (DE, BE, FR, IT, UK).

“overall juste retour” covering several years and several programmes.

While the European States hesitate to overcome the fragmentation of their armaments policies, many of the structures and processes related to the defence market and armaments production have become strongly internationalized. Defence companies are competing in an increasingly globalised environment for profits and market shares.

These changes were due to the sharp reductions in defence budgets in the 1990s. Like the US, Europe experienced a consolidation of production capacities through acquisitions, mergers and rationalization efforts. The result was a concentration of production capacities in the shape of large, occasionally multinational defence corporations such as BAE Systems or EADS. At the same time, the network of subcontractors, i.e., suppliers of components and parts, has become more transnational. Due to the decline of domestic demand, there is an increasing need to boost exports in order to ensure that production lines operate at full capacity and to remain competitive regarding unit prices via “economies of scale”.

Thus, the shrinking of markets has led to their globalization. This tendency is likely to continue as long as investments in the domestic markets do not increase significantly.

For suppliers, to compensate to some extent for these price increases, the participation in the international markets and production chains has become indispensable. Here, especially small and medium-sized companies - without national branches in every important state - depend on simplified access to these markets. However, not only they but all non-domestic suppliers collide with the prevailing practice of governments. The governments tend to protect their national markets and suppliers e.g. through individual procurement policies and regulations for tenders. They tend to prefer domestic contractors and hinder international competition and participation in domestic tenders. Exempted from this practice are only major companies that act as prime contractors in intergovernmental framed multinational procurement projects. However, such projects the practise of “juste retour” - i.e. the distribution of the budget to the participating suppliers along a politically consented distribution key - still hinders the reinforcement of a solid industrial base.

Economic pressure towards structural changes that can enhance efficiency and reduce costs is obstructed.

The prevailing pursuit of national armaments policies no longer reflects the market realities of the armaments sector. While the current practice attempts to ensure the survival of individual companies in the short term, in the longer term they prevent the necessary consolidation of the defence industrial sector in Europe.

The Directive 2009/81 does not apply to cooperative programmes, which due to the shrinking budget might become more and more common in the future. But is it correct the parallel cooperation hence no competition? Conversely many cooperative programs, like JSF, MEADS, and the Tanker acquisition prove, competition can still take place, if Governments are committed to it.

The financial crisis has certainly boosted negotiations and initiatives for more international cooperation and a complex framework of overlapping cooperation clusters currently unfolds.

A TRANSATLANTIC MARKET

What if the way ahead lies both in stronger cooperation within Europe, combined with the implementation of a real transatlantic market? As said, the current financial crisis had a profound impact on the shrinking of the resources attributed to Defense budget all over Europe, and yet it was combined with an increasing European involvement in crisis all over the world, hence EU Member States face an even greater trade off.

Across the Atlantic the situation is not very promising either: the cost of the Global War on Terror has put the Department of Defence under unprecedented pressure: President Barack Obama signed the defense authorization act on January 7, putting into practice the \$725 billion defense budget for fiscal 2011 that Congress had passed. Congress passed the bill in December, very late in the year after lengthy wrangling. Lawmakers removed or modified many controversial provisions, such as one that would have allowed officials to ban a contractor without notice under certain conditions. Starting with the next budget, for fiscal 2012, Defense Secretary Robert Gates' proposed measures for reducing costs may begin to manifest. Gates' plan is a three-year effort to

carve away 10 percent of the staff-support contractors that DOD employs, slash \$10 billion from IT expenditures and cancel some expensive weapons systems. The moves come as the Pentagon faces \$13 billion less than initially planned for in the fiscal 2012 budget.

A transatlantic defence market matters for industries: in order to compensate for defence spending cuts, defence industries multiply cross border partnerships. Lockheed Martin has established eight joint ventures with European firms and participate in several collaborative programmes around the world for example JSF. How can the EU and US spend better in the defence field?

One possible answer could be increasing the cross border competition, including across the Atlantic: in other words increasing the competition within the cross border cooperation. In fact as previously pointed out, even after the defence procurement reform, EU Member State retains a great deal of latitude when to apply art.346 or whereas derogate to the general rule or not. Also pooling resources and innovation would be the most productive strategies for European governments

Yet if we now turn to the real life scenario we see that Defense industrial cooperation across the Atlantic is striving.

The number of official transatlantic defense programs is minimal. Increasingly, for major defense acquisition programs, such as air transport and missiles, European governments prefer to "buy European," while the U.S. tradition is of "buy American" .

Industry joint ventures such as Thales-Raytheon Systems, have yet to generate business growth. Strategic partnerships, such as that between EADS and Northrop Grumman, have yet to bear significant fruit in the form of access for firms on one side of the Atlantic to the defense market on the other side. The most successful transatlantic market access has gone to the few, largely British defense companies (especially BAE Systems and Rolls-Royce) that have established themselves in the only growing defense acquisition market in the transatlantic region - the United States.

There are significant and growing obstacles to achieving a more open and flexible transatlantic regime for defense industrial and technological cooperation. Most of these obstacles are the result

of government policies, principally in the United States, but increasingly in Europe, as well. Despite these negative signs for the transatlantic industrial relationship, the logic of stronger defense industrial and technological cooperation remains compelling. For this logic to prevail, however, the transatlantic obstacles will need to be overcome. It is not yet clear that policy-makers are prepared to take the necessary steps, but the policy options are relatively clear.

For both the US and Europe, a more integrated industry and technology regime that incentivized industry collaboration would provide defense policy-makers with enhanced choices, competition and flexibility in defense acquisition. As industry has consolidated, the number of providers of defense platforms has declined, constraining defense ministry options in Europe and for the DOD. The advantages of competition, in pricing, technical capability and timing, are slowly being lost. A broader array of technical options would be available for defense planners and costs could be better controlled, a significant advantage within constrained investment budgets.

The communications, information, networking, sensing and satellite technologies that are critical to network centric warfare and combined operations are widely dispersed and commercial in origin. The capacity to integrate these technologies into military applications is less dispersed, limited largely to American and a very few European companies. European firms, particularly Thales, BAE Systems and EADS, possess the commercial technologies in abundance and are increasingly capable of integrating those technologies in defense systems. There are clearly advantages to greater flexibility in the technology transfer regimes between these two continents and significant downsides to either side shutting itself off from the technologies available to the other side. A flexible regime across the Atlantic for such technology transfers, combined with more common barriers to its dispersal elsewhere, could be in the interests of both.

As developments in the European shipbuilding, ground systems, and aircraft industries suggest, it is increasingly difficult for European industry to sustain itself on European acquisition spending, alone. Given such limits, the incentive for European defense industries to gain access to the US market is growing. Major US defense firms, while less dependent on the international market, are losing their historic access to the

European market. Traditional access to Europe through direct sales is no longer acceptable. Only partnerships with European firms will provide future access and these are viable only if there is reciprocity in the policies governments pursue on both sides.

The defense industry on both sides of the Atlantic has recognized and responded to these incentives for greater cooperation for a number of years now. The same cannot be said for government policies, which create growing obstacles to a more flexible transatlantic regime.

The barriers to entry into the American defense market are major obstacles to a more transparent, open and flexible transatlantic defense industrial relationship. They are largely based on government policies, many of which have existed for decades and are difficult to change. Defense Department acquisition and defense trade policies are major obstacles. They include a strong and understandable DOD preference for buying US defense technologies, which are seen as significantly more advanced than comparable European technologies. There is also a strong DOD preference to protect US defense technological leadership and carefully restrict European access to US technical know-how. These preferences are reinforced by a guarded DOD approach to technology transfer and direct foreign investment by non-US defense suppliers in R&D and production facilities in the United States.

Beyond DOD, 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 their Munitions List to any other country, including members of the EU. Export control rules written during the Cold War have been extended since then, with the policy bureaucracies remaining concerned about the risk of the loss of technological superiority and the proliferation of capabilities that could be used, one day, against the United States.

CONCLUSIONS

Although it is not the purpose of this paper to examine European policy closely, it is worth noting that the historically open European defense market may be in the process of closing substantially, as part of the "Europeanization" of overall defense policies and

defense industrial policies, in particular. The EU commitment to the Headline Goal, declining European defense budgets, and the consolidation of the European defense industry are having an impact on European defense acquisition decisions and emerging defense industrial and technology base. Gradually, a tendency may be emerging to protect the European defense industrial and technology base from American domination, and to sustaining a European industrial and technological capability to sustain and support the broader security goals of a uniting Europe.

The "buy European" preference may be indicated by the European commitment to the Meteor missile and the A-400M transport aircraft. These two decisions could signal a future in which EU members buy major hardware platforms from European suppliers, with smaller procurements being more transatlantic. European governments have encouraged the creation of European counterparts and competitors to US defense industrial giants to meet these needs and, as the Headline Goals of the CSDP have been more sharply defined, these capabilities are being looked to for the necessary equipment and technologies, including air transport, sealift, precision guided munitions and unmanned aerial vehicles.

There is also a growing cross-national trend to create European-level institutions and policies to provide the legal setting and road map for European defense acquisition policies and defense industry behavior. Such harmonization is seen as necessary for a healthy, cross-national industrial base, as well as to ensure that this industry does not escape governmental scrutiny and controls. Under the July 2000 "framework agreement" six countries (UK, France, Germany, Italy, Sweden and Spain) have undertaken to harmonize practices and regulations on export controls, security of supply, the security of classified information and industrial security, defense research and development, the treatment of technical information, and defense requirements.

Four of these nations – France, Germany, the UK and Italy – have also created a joint defense acquisition organization in 1996 – known as OCCAR for its French name (Organisation Conjointe de Cooperation en Matière d'Armement) to manage the growing number of collaborative programs among these countries, including, ultimately, the A400M. OCCAR is increasingly seen as the prototype of a European defense acquisition agency, which

may emerge in the EU framework with expanded membership sometime in the future.

As the EU member states protect employment in the defense industry and move to stimulate a European R&D technology base in advanced defense technologies, two tendencies may appear. First, European level institutions will be increasingly tasked with regulatory responsibilities for this activity. As one EU official has put it: "You cannot have a defense policy for 15 and an industrial base harmonized at six." Second, this emerging European industrial and technology base will be protected from the United States. European governments will be willing to pay a premium for defense equipment, and acquire slightly less advanced technology, more slowly, in order to support this base. But the full extent of the financial crisis hasn't shown yet. And already, whilst among the bigger producing countries, France, Germany, the UK or Italy, there is a continuing tendency to maintain as broad a range of national production capacities as possible; non-producing countries, on the other hand, do not even necessarily purchase their Defense products on the European market, but choose other suppliers, especially from the US. Therefore I would conclude in favor of the implementation of a concrete transatlantic market devoid of all protective measures on the one side or the other, but the possibility of this happening is still quite far away.

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