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The Role of the Governments and Governmental State Aid on Hard-Defence Material Sector in the EU

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May 2004

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Abstract

Trade, procurement and production of hard-defence material and equipment are outside of the legislation of the European Union. This is possible due to the existence of Article 296 EC. In this thesis the hard-defence material sector and especially the factors affecting operation and competition within the sector are introduced. The governments of the Member States in the European Union have a strong impact on the operations of the hard-defence material industry. One of the ways the governments affect the operations of the industry is by state aid. In this thesis the object is to see what is the role of the governments of the Member States and state aid on hard-defence material industry. In order to reach a conclusion both legal and business perspectives are studied. The legal framework of this study comes from the legislation of the European Union. Primary and secondary legislation are used to study the legal environment of the hard-defence material sector in the European Union as well as to learn, how this legislation is applied. A theory concerning a competition within an industry is applied to study the industry and factors affecting the competition in the hard-defence sector. A theory related to trade strategy of states and impact of state support is used to see that the state aid can be beneficial as well as non-beneficial. These approaches are combined in order to get a comprehensive picture and in order to reach the answer to the object. This study highlights the strong role of the governments. The government's have a strong impact on the industry and it is found sometimes problematic. The state aid in hard-defence sector is found to have sometimes a negative impact but for some purposes it is found to be necessary. However, a change may be on its way and some changes have been suggested regarding to the future development of the hard-defence sector in the European Union.

Key words: Hard-defence material industry, Article 296 EC, State Aid, the European Union, the governments

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1. Introduction

1.1. Subject Area

Free trade and high degree of and fair competition are some of the goals of the European Union and there is a common legislation covering those fields in the European Union. The legislation is meant to ensure that fair trade and competition happen in the common market. The armament, however, has been outside the domain of the European Union and the production, trade and procurement of military products¹ have been outside of the integration process of the European Union. The Member States of the European Union have wanted to keep this field under national governance. This has been made possible through exemption based on security of the nation granted in Article 296 of the EC Treaty.²

In recent years there have been attempts to establish common policies and to have cooperation on armament issues in the European Union. For example the Commission has quite actively looked for ways to create common policies to this sector for example through its Communications. However, purchasing and selling of the defence material and services, fall still quite often outside the regime of the EC legislation.

The defence equipment companies in Europe are not doing well and are lacking behind in the competition with the defence companies from the United States³. In addition, the defence budgets of the governments have declined at the same time when the costs of defence equipment have increased⁴. Due to the current situation the states are more willing to look for more cost-effective solutions as well as to look for possibilities for armament cooperation within the Union⁵.

Further integration of the defence sector is one of the current issues handled in the European Union. Among other things, Article 296 EC hinders the efforts to unify defence industrial policy within the European Union. Furthermore, it creates a possibility for anti-competitive behavior on both demand-side (governments) as well as on supply-side.⁶ This

¹ The definitions are available at the end of Chapter 1.

² Schmitt, Burkard, *The European Union and Armaments, Getting a Bigger Bang for the Euro* (2003) p. 9.

³ Schmitt, Burkard, *The European Union and armaments, Getting a bigger bang for the Euro* (2003) p. 12.

⁴ Hartley, Keith, *Defence Economics and the Industrial Base*, p. 1.

⁵ Schmitt, Burkard, *The European Union and Armaments, Getting a Bigger Bang for the Euro* (2003) p. 7 - 8.

⁶ Hartley, Keith, *Defence Economics and the Industrial Base*, p. 17.

Article makes it possible for the governments of the Member States for example to grant state aid for domestic companies⁷. This has been claimed to have an adverse effect on competition⁸. In addition the state aid regimes of the Member States directed to defence companies are not always seen beneficial for the state⁹.

Due to the strong impact of Article 296 EC it is an interesting issue to elaborate more on. In this thesis I will concentrate on the role of the Member States and especially on the role of state aid made possible for the defence companies through Article 296 EC on the hard-defence sector.

1.2. The Purpose and the Problem of the Study

The focus of this study is on the impact of the Member States through Article 296 EC and especially on the role of governmental state aid. The main question of this study is:

What is the role of governments and governmental state aid, which is made possible by Article 296 EC, on hard-defence material sector in Europe?

I chose this subject because the governments seem to have a strong impact in the hard-defence industry and state aid is still quite common in the industry. Furthermore, it has been claimed that one of the most important ways that the states can distort trade is through state aid¹⁰. Furthermore, trade on hard-defence material falls outside the legislation of the European Union and is governed by the national legislation of the Member States. This is possible through Article 296 EC. These factors make it interesting to study more this field. Furthermore, due to the strong impact of the governments it is interesting to study the role of governments and especially the role of state aid on hard-defence sector.

Moreover, this field is interesting, because not only the economic side can be taken into account. The special nature and sensitivity of the field creates a different kind of business environment, which should be taken into consideration.

⁷ See Commission Decision 1999/763/EC, 17 March 1999 and Case T-26/01, 30 September 2003.

⁸ Trybus, Martin. *European Defence Procurement Law: International and National Procurement Systems as Models for a Liberalised Defence Procurement Market in Europe* (1999) p. 94.

⁹ Anonymous, *UK Government Subsidies to the Arms Trade, Outline of 'The Subsidy Trap' report*.

¹⁰ Korah, Valentine, *An Introductory Guide to EC Competition Law and Practice* (2000) p. 152.

There have been initiatives in the European Union and outside the European Union to change the current situation of the armaments industry and enhance cooperation in Europe. For example some organisations exist for cooperation between the countries. In addition, for example the Commission of the European Union has been active. Also, the European Council decided in Thessaloniki in June 2003 that a European Armaments, Research and Military Capabilities Agency would be established. Thus, changes may be on their way, but it will remain to be seen, what is the concrete outcome, because there are still unsolved problems. For example the Member States have different interests and due to the special nature of the industry some states are concerned for example about the security of the supply of arms.¹¹

So, the hard-defence sector and trade in this sector is interesting field to study due to its special nature. In recent years quite many studies have been made about defence industry in Europe. Many studies and essays concern the current situation of the industry in the European Union and the challenges the industry faces. In addition, the recent development of the industry is often studied in different studies related to armament industry. There are also some studies that take a closer look at the impact of governments as well as at state aid.

So, the main purpose of this thesis is to answer the above-mentioned question, and thus, this thesis concentrates only on this narrow field, i.e. the role of governments and especially the role of state aid are mainly studied.

Then at the end, after answering this question, I will present the suggestions of the Commission of the European Union regarding the scope of Article 296 EC as well as the reaction of the European Economic and Social Committee on the proposal. In addition, at the end of this thesis I will include some own discussion on this issue.

1.3. The Plan of the Study

In this study I will concentrate on the above-mentioned question. In this first Chapter, I will present the outline of the study. In the second chapter I will go through the legal and analytical framework that is used in this thesis. In that chapter I will go through the legislation as well as theories applied later in this study. In the third chapter, I will present the current situation of the industry and especially the factors affecting competition on armament industry

¹¹ See Schmitt, Burkard, *Armaments cooperation in Europe*.

through Porter's five forces framework. In the fourth chapter I will concentrate on application of Article 296 EC in the European Union. In the fifth chapter I will analytically go through the role of the state aid regimes made possible through Article 296 EC and reasons against and for the regimes. In the sixth chapter I will present the findings of my study. I will combine the findings of the earlier chapters, which concern the industry, the application of Article 296 EC and the state aid in hard-defence sector. Then at the end, I will go through the future suggestions for the scope of Article 296 EC and discussion related to it. Finally the last chapter will include the final conclusion of this thesis.

1.4. Demarcations

I will not go through the whole competitive legislation of the European Union, because in this thesis the main focus is on the state aid. Thus, I will only concentrate on the competition legislation of the European Union, which concerns this study and state aid.

There are other Articles as well, which may provide exemption to measures concerning the trade in goods for military purposes. These will be covered in this study, but as the focus is on Article 296 EC, their impact will not be studied in depth. These Articles concern mostly trade on dual-use goods for military purposes and this thesis concerns hard-defence material sector¹².

From the point of view of the competition law of the European Union especially possibility to apply merger control and state aid legislations in defence are seen interesting. In this thesis I concentrate on the effects of the state aid due to the fact that defence mergers fall already quite often under the provision of Community legislation if civilian activities are in concern as well. In addition a general view is that monopolistic positions are more easily accepted due to the strong position of governments as main unless as only customers, as regulators and as sponsors. In addition, due to the situation of the industry and competition it may be that the governments have to accept national or even European wide monopolies to maintain the industry in Europe.¹³ In this thesis I have decided to concentrate on how the state aid may affect the trade and competition.

¹² The definitions are available at the end of Chapter 1.

¹³ Schmitt, Burkard, *The European Union and Armaments, Getting a Bigger Bang for the Euro* (2003) p. 56 – 57.

In addition, because public procurement of defence material is related to the trade in the defence industry I will briefly cover it as well. However, I will not cover deeply the differences in different procurement legislations applied in procurement of defence material, or go through in detail the public procurement legislation referred to in this thesis, because the main focus of the thesis is not on these issues. Thus, the public procurement and legislation and other issues related to it are covered only as deeply as it is needed to make the point clear.

There has been a lot of discussion about competitiveness of the European defence companies compared to the defence companies in the United States, which is at the moment the biggest producer of defence equipment. However, although being important field to the European armament policy as well as being strongly related to the scope of Article 296 EC, I have decided not to cover the competition with the U.S. companies in detail, but on the level necessary for this thesis. This is, because the main purpose of the study is on the impact of the states through Article 296 EC and state aid on the defence companies in Europe.

1.5. Methodology

1.5.1. Perspective

When I was thinking about the subject area of my study, I wanted to write about defence purchasing. I started to look for and read information related to the defence sector in order to get a better picture of what is the situation of the defence sector and the defence purchasing in the European Union. Before starting I had already some knowledge about the trade and purchasing in the defence sector. I knew for example that part of the purchasing of defence forces fall within the public procurement legislation of the European Union but part is still outside the regime of the EC legislation.

While studying the subject more I noticed that the defence industry in the European Union is not doing good and that many parties, for example a big defence company, industry associations, as well as an institution of the European Union, were looking for change. They were for example looking for a possibility for further cooperation in the European Union in order to enhance the situation of the companies. I also found out that the competition was

adversely affected through different ways, for example through state aid as well as policies to purchase domestic products.

I got interested in the problems affecting trade and competition in the industry and why there are no common policies within the European Union. Existence of Article 296 EC and the actions of the governments as well as the resistance of the Member States to open up the armament sector were raised in many studies as reasons. Thus, along the way I changed my focus to study the impact of Article 296 EC.

While studying more, the strong impact of governments became clear. In addition, the state aid and the way the states use tax money in defence sector was raised up. Thus, finally, I decided to focus on the impact of governments through state aid on the hard-defence sector. I concentrate on hard-defence sector due to the fact that Article 296 EC applies only to products that are for military purposes.

I will look into the subject of my study from the perspective of the governments as well as suppliers. However, the focus is mainly on the side of the governments of the Member States, which play important roles in the hard-defence sector as legislators, customers and investors. The side of the defence material companies, however, is looked into as well. I will handle the issue on the European Union level and not describe a legislation or defence industry of each Member State in detail. Thus, I will look into the effects of Article 296 EC and state aid regimes in the European Union.

1.5.2. Theories

This thesis concerns the role of governments of the Member States as well as the role of state aid made possible by Article 296 EC in hard-defence sector. This thesis reflects both the legal and the business perspectives of this subject, and this thesis is based on qualitative approach.

First of all, Article 296 EC creates a framework for this study as it creates the framework for the trade of military equipment in the European Union. In this thesis this Article is presented and explained. In addition, a Decision of the Commission of the European Union as well a case of European Court of First Instance are studied in this thesis to see, how this Article is really applied in the European Union.

In order to understand the industry and the factors affecting competition within the industry the Porter's five forces of competition framework is used in this thesis. As I

mentioned before, I did not know before hand that that the situation of defence companies is not so good in Europe. Thus, through Porter's five forces I want to look into the industry and see what are the factors affecting the industry and competition within the industry.

As I focus in this study on the role of state aid I decided to apply a theory of Barbara Spencer and James Brander to see how subsidies can affect the trade and competition in one industry and how they can be beneficial as well as non-beneficial. They focus in their theory on the impact of strategic trade policy of governments and subsidies and how the competition is affected.

So, Article 296 EC gives the framework for the whole study and the two cases, one from the Commission and one from the European Court of First Instance explain the application of this Article in the European Union. In order to get to know the industry and factors affecting the competition in the hard-defence industry the Porter's five forces model is used. Then through Brander-Spencer theory the possibility of subsidies being beneficial as well as non-beneficial is studied. I believe that these three approaches will help me to answer the question mentioned earlier in this thesis. Thus, I will combine the findings of these parts to answer the question. To answer the question it is important to know, what is the legal framework and how it is applied in the European Union. Furthermore, before analyzing the role of state aid in the industry it is important to have information about the industry. Thus, I believe that these three parts studied in this thesis, which are related to law and business issues, can be used to answer the main question of this thesis very well.

In addition, as mentioned before, at the end of this thesis I will go through the suggestions of the Commission concerning the scope of Article 296 EC. Although they are only proposals, they give the opinion of the Commission concerning this matter. Also, I will go through the opinion of the European Economic and Social Committee on the suggestions of the Commission. Furthermore, I believe that the answer to the main question gives more value for the information of this chapter concerning the future suggestions, because then the reader has background information about the current situation in the industry.

1.5.3. Limitations of the Theories Applied

There are some limitations in the choice of theories. The Brander-Spencer theory has got criticism. It has been criticized due to the difficulty to have enough information so that it

would be really applicable. In addition, it has been criticized for not taking other industries or the customers into account. Although this theory has got criticism I decided to use it. This is because I am not trying to use it in a way it has been criticized, i.e. to explain how the governments could know when a subsidy is beneficial and when it is not, but I will use it to explain and make it clear that sometimes the subsidies can be beneficial but sometimes they are not. This is because in the hard-defence industry it has been deemed that some state aid is not good but some state aid is needed.

In addition, I could have tried to study more economical view of effects of subsidies and go really deep in the possible impacts of subsidies. However, my opinion is that Brander-Spencer theory explains as deeply as it is needed in my study the idea that state aid may be beneficial but on the other hand it may not.

In addition, the role of governments of the Member States is quite strong in the hard-defence industry. When using the Porter's five forces framework the power of the buyer in this case reflects the power of the governments, because they are normally the only buyers of hard-defence equipment. The power of the buyer does not, however, help to explain thoroughly the power of the governments. Thus, in that part I will use also Porter's studies concerning the role of government in order to explain the impact of governments.

1.5.4. Literature Review

The amount of literature related to the trade and competition on hard-defence material industry is limited. There is literature covering the competition aspect from business and legal perspective as such. However, it is difficult to collect literature related to defence industry. However, recently there have been more interest in this field and more studies have been made. Especially, studies have been made in the United Kingdom, which is one of the biggest defence industry nations in the Europe.

I was not able to use many books related to armament industry, but there are good articles related to the subject, which have helped me to get into the subject and analyse the situation and impact of Article 296 EC and state aid regimes. These studies are made recently and made by organisations and universities. Thus, the information should be relatively good and trustworthy, as well as mostly objective. Some articles used may be biased to one direction, but I have tried to take it into account.

One of the organisations, whose articles are used in this study, is Institution of security studies, an agency of the European Union. It has studied security and defence issues of the European Union. They have some articles, which are related to my study and which I have used.

Moreover, defence procurement as other defence related issues are quite sensitive subjects and thus, the states may not be willing to reveal facts and issues that are not required to be revealed. However, because I will not handle the defence procurement or other defence related issues from the point of view of one particular country but concentrate on the issues on the European Union level I have tried to find information concerning defence procurement and other issues needed in the thesis on the level of the European Union.

The search of articles and books is done through libraries, which are located near by and in the Internet. The theories used in this thesis are mainly found in the books that are not written by the theorists themselves, which can be considered as a limitation for the literature used in this thesis. I was able to get two books written by Michael Porter and they are used when applicable. However, the other book was in Swedish and my Swedish knowledge is not good enough to translate it with certainty to English. Thus, in order to have valid and trustworthy data, I have used source literature that is in English, although then the information concerning Porter's five forces is from a book of another author. Also, the information of the theory of Brander and Spencer is from a book written by another author. However, I believe that the books used cover these theories deeply and objectively. So, I believe that the theories and the information of the theories, which I got from these books and which are used in this thesis, are trustworthy and applicable, although the primary source is not used.

In addition, as a limitation for this study, I was not able to get the whole 'Subsidy Trap' report written by Ian Davis and Paul Ingram. Thus, the information concerning the report is got from the article *UK Government Subsidies to the Arms Trade*, which is an outline of the report.

The legal data in this thesis consists of primary and secondary legislation of the European Union. In addition, in order to clarify these legislations books concerning the EU law have been used. I have read these books in order to understand and learn more about the subject of my thesis as well as the related issues. These books are from recent years and thus give quite current information about the legislation of the European Union.

The primary and secondary legislation is used directly in this thesis, not through other sources. The other sources are mainly used to explain issues related to the legislation applied

in this thesis. However, I was not able to find the Communication of the Commission COM(96) 10. It is not available on the homepage of the European Union in the Internet. In addition, unfortunately, it was neither in the law library of the Lund University. Thus, the information about this Communication and what it includes is got from a book concerning public defence procurement law. The data from the other Communications of the Commission used in this thesis are got by reading the final versions of the Communications.

By using this legal data I believe that I will be able to present a neutral and clear picture of the current application of Article 296 EC. In addition, with this data I believe that the future suggestions of the Commission concerning Article 296 EC are presented objectively.

By combining the information received by reading information concerning the defence sector with the legal information as well as with the data from the business theories applied in this thesis, I believe that I can give a good picture of the situation in the industry as well as the role of governments, through Article 296 EC, and state aid on defence sector. Thus, I believe that the question mentioned earlier can be answered well with this data.

1.6. Definitions

Hard-defence, defence sector/industry, armament industry mean in this study the companies producing hard-defence or military material and equipment in the European Union. It does not mean production of soft-defence or dual-use goods.

Hard-defence and military material and equipment mean in this study goods produced for military/defence purposes. In this thesis material that falls within the regime of Article 296 EC belongs to this group¹⁴. The list of such material is attached in this study as Appendix 1.

Soft-defence material and dual-use goods mean in this study material and goods, which can be used either for civil or military purposes. These material and goods do not fall within the regime of Article 296 EC (for example tents, and transport aircraft).¹⁵ Not even in a case when they are meant for military purposes. They may, however, be exempted based on public security, for example through Article 30 EC.

¹⁴ Trybus, Martin, *European Defence Procurement Law: International and National Procurement Systems as Models for a Liberalised Defence Procurement Market in Europe* (1999) p. 15.

¹⁵ Trybus, Martin, *European Defence Procurement Law: International and National Procurement Systems as Models for a Liberalised Defence Procurement Market in Europe* (1999) p. 15.

There is more than one definition for *state aid*. In this study the definition of the Commission of the European Union and the European Court of Justice is applied. The definition is quite broad and it does not only include subsidies but also actions, which may decrease costs or charges a company would otherwise face. The Commission has made a list of such state aid, which, however, is not exhaustive. It includes factors such as subsidies, tax exemptions, preferential interest rates, the provision of land or buildings on special terms, indemnities against losses, preferential terms for public ordering, etc.¹⁶ The aid is seen as a state aid if it is given by a 'Member State or through State resources' including regional and central government. Moreover, it may include a public or private body established by the State.¹⁷

A *subsidy* in this thesis means a payment made by a government to a domestic producer. There are many forms of possible subsidy payments. These can be for example cash grants, low-interest loans, tax breaks, and equity participation in domestic firms.¹⁸

¹⁶ Craig, Paul & De Búrca Gráinne, *EU Law: Text, Cases, and Material* (2003) p. 1141.

¹⁷ Craig, Paul & De Búrca Gráinne, *EU Law: Text, Cases, and Material* (2003) p. 1144.

¹⁸ Hill, Charles W. L., *International Business, Competing in the Global Marketplace* (2001) p. 154.

2. Legal and Analytical Framework

This study concerns the impact of the Member States, through Article 296 EC, and a possibility to grant state aid on the hard-defence sector. In this Chapter the legal and analytical frameworks, which are applied later in the study, are introduced. The legal framework of this work includes Article 296 EC, which gives the Member States a possibility to apply their own legislation if the security of the nation is in concern, as well as Article 87 EC, which is about state aid.

The analytical framework from the business perspective includes Porter's five forces framework, which helps to analyse the current situation of the industry. In addition, a study related to the impact of government subsidies is part of the analytical framework of this study. These theories are introduced later in this chapter.

2.1. Legislation Concerning the Hard-Defence Material Sector in the EU

As it has been mentioned before many activities on the defence sector and commercial activities of both purchaser (normally governmental organisations) and companies fall outside the regime of the EC legislation. This is possible especially due to the Article 296 EC, which reads as follows:

- 1) *The provisions of this Treaty shall not preclude the application of the following rules:*
 - 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.*

- 2) *The Council may, acting unanimously on a proposal from the Commission, make changes to the list, which it drew up on 15 April 1958, of the products to which the provisions of paragraph 1(b) apply.*¹⁹

The second point of this Article refers to a Council's list of products on which this Article can be applied. New interpretations on the list (Appendix 1) made in 1958 were made in 1978. The changes were made in order to have the list updated with new technical progresses.²⁰

This Article 296 EC creates a legal framework for the operations of the defence sector in the European Union. It makes possible for the Member States to have the trade in hard-defence material under the national legislations. Article 298 EC can be used in situation where Article 296 EC is applied and in which the actions taken have also an effect of restricting competition on products that are not especially for military purposes. In such a case the Commission together with the Member State shall look for a way to adjust the measures to be compatible with the Treaty.²¹

In addition to Article 296 EC, Article 297 EC grants the Member States a right to exemptions for example in a case of a war. Furthermore, Articles 30, 39, 46, and 55 EC concerning fundamental freedoms include an exemption for measures that are needed because of national security. These exemptions concerning Articles related to the fundamental freedoms can be used for example in the situation of dual-use goods or soft-defence material, which are not covered by Article 296 EC. As these are material that are usable for both civil and military purposes contrary to hard-defence material, e.g. tanks or missiles, which are covered by Article 296 EC and mentioned in the list.²²

The Commission has stated that Article 296(1)(b) EC can be invoked only by the Member States. Then the competition rules of the European Union could be applied on the defence sector when a company has taken restrictive activities itself without requirement or encouragement of the state. So, the companies cannot invoke this Article alone. However,

¹⁹ Treaty Establishing the European Union.

²⁰ Trybus, Martin, *European Defence Procurement Law: International and National Procurement Systems as Models for a Liberalised Defence Procurement Market in Europe* (1999) p. 14.

²¹ See Case T-26/01, *Fiocchi Munizioni SpA v. Commission of the European Communities*, point 63.

²² Trybus, Martin, *European Defence Procurement Law: International and National Procurement Systems as Models for a Liberalised Defence Procurement Market in Europe* (1999) p. 15 - 17.

the application of this Article is not entirely clear. A court case would clarify the situation, but there has not been one yet.²³

2.2. Legislation Concerning the State Aid in the EU

In the European Union there are legislation covering competition in the common market. There are Treaty Articles covering different issues of competition and Article 87 EC concerns state aid and it reads as follows:

1. *Save as otherwise provided in this Treaty, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favoring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the common market.*
2. *The following shall be compatible with the common market:*
 - a. *Aid having a social character, granted to individual consumers, provided that such aid is granted without discrimination related to the origin of the products concerned;*
 - b. *Aid to make good the damage caused by natural disasters or exceptional occurrences;*
 - c. *Aid granted to the economy of certain areas of the Federal Republic of Germany affected by the division of Germany, in so far as such aid is required in order to compensate for the economic disadvantages caused by that division.*
3. *The following may be considered to be compatible with the common market:*
 - a. *Aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment;*

²³ Trybus, Martin, *European Defence Procurement Law, International and National Procurement Systems as Models for a Liberalised Defence Procurement Market in Europe* (1999) p. 81 – 82.

- b. Aid to promote the execution of an important project of common European interest or to remedy a serious disturbance in the economy of a Member State;*
- c. Aid to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest;*
- d. Aid to promote culture and heritage conservation where such aid does not affect trading conditions and competition in the Community to an extent that it is contrary to the common interest;*
- e. Such other categories of aid as may be specified by decision of the Council acting by a qualified majority on a proposal from the Commission.*²⁴

The first point of this Article states that state aid is incompatible with the principles of the common market. It does not provide a definition of state aid. Through different cases the Commission and the European Court of Justice have adopted a quite broad definition for state aid. As stated before in the definition chapter, according to the Commission and the Court it does not only include given positive benefits, such as subsidies, but also actions that might lower the costs or charges a company would normally face. The Commission has provided a list of different kind of aid including for example subsidies, tax exemptions, preferential interest rates, the provision of land or buildings on special terms, indemnities against losses, preferential terms for public ordering, etc. This list is not exhaustive.²⁵ Moreover, this Article includes only the aid which is given by a ‘Member State or through State resources’. This includes regional and central government and it may include a public or private body that is designated or established by the state.²⁶ In addition, only the aid, which affects the competition between the Member States and thus, may adversely affect a company in another Member State, falls within this Article and is under the control of the Commission²⁷.

Article 87 (2) EC includes aid, which is seen to be compatible with the common market, and Article 87 (3) EC includes aid, which may be deemed to be compatible with the

²⁴ Treaty Establishing the European Union.

²⁵ Craig, Paul & De Búrca Gráinne, *EU Law: Text, Cases, and Material* (2003) p. 1141.

²⁶ Craig, Paul & De Búrca Gráinne, *EU Law: Text, Cases, and Material* (2003) p. 1144.

²⁷ Korah, Valentine, *An Introductory Guide to EC Competition Law and Practice* (2000) p. 152.

common market.²⁸ So, state aid may be acceptable and the Commission has the discretion to create the general approach taken to state aid. For example, it has applied on its decisions a principle of compensatory justification. This means that before the Commission accepts the aid, it has to be deemed to have a beneficial impact in the attainment of the Community objectives.²⁹

Through Article 86 EC the Competition legislation of the European Union applies to public undertakings as well, to which otherwise the states have granted special or exclusive rights. This is, as long as these rules do not hinder the performance of the task assigned to such undertakings.

2.3. Framework for Analysis of Factors Affecting Competition

There are many factors within an industry, which affect the nature and the intensity of the competition in an industry. Porter's five forces of competition framework is a tool to analyse an industry. It can be used for analysing the profit potential of the industry³⁰. The five forces, which have an impact on competition, are classified by Porter as being the threat of possible competition from substitutes, competition among current rivals, and the threat of potential new companies entering the market, as well as the bargaining power of suppliers and the bargaining power of buyers.³¹ In the following section the five forces and the factors affecting competition within these forces are presented.

Industry rivalry: Competition within an industry is very important factor in determining the level of profitability of the industry and the following factors affect the competition in the industry:

- level of concentration in the industry,
- diversity of competitors,
- product differentiation,
- excess capacity and exit barriers,
- cost conditions.

²⁸ Craig, Paul & De Búrca Gráinne, *EU Law: Text, Cases, and Material* (2003) p. 1146 - 1147.

²⁹ Craig, Paul & De Búrca Gráinne, *EU Law: Text, Cases, and Material* (2003) p. 1138.

³⁰ Porter, Michael, E., *Konkurrensstrategi* (1994) p. 25, 50.

³¹ Porter, Michael, E., *Konkurrensstrategi* (1994) p. 26.

The level of concentration means the number of companies competing in the industry and their relative sizes. The diversity of competitors and the product differentiation concerns how well the company can differentiate itself and its products from competitors and their products. The excess capacity and exit barriers concern the balance between demand and capacity and how difficult and costly it could be to leave the industry if there is overcapacity. When for example there is excess capacity that causes price competition, there is a question about how down the price will go, and it depends on the cost structure. The cost conditions include for example the ratio of the relationship between fixed and variable costs. This could indicate how willing the companies might be to decrease price to utilize spare capacity.³²

Threat of entry: If the industry is profitable other companies outside the industry may be interested in to enter the market. The following factors can be possible barriers to entry existing within an industry, which hinder the willingness of new companies to enter the market:

- economies of scale,
- absolute cost advantages,
- capital requirements,
- product differentiation,
- access to distribution channels,
- government and legal barriers,
- retaliation by established producers.

Need for economies of scale is common for industries that are for example R&D oriented. There is a need for large-scale operations in order to have the unit costs low. A new company entering the market faces a problem whether to start as big with high risk or start as a small company and face high unit costs. In addition, capital requirement to start to produce may be so high that it discourages new possible entrants from entering the market. Furthermore, the companies entering first may enjoy of absolute cost advantage, which could be for example reached through acquisition of low cost sources or through economies of learning. In addition, limited amount of distribution channels may act as a barrier to entry. Also, if the existing companies have differentiated products the existing companies may enjoy of brand recognition and customer loyalty creating difficulties for a new company willing to enter the

³² Grant, Robert M., *Contemporary Strategy Analysis* (1998) p. 58, 61 – 63.

market. Moreover, the barriers borne from government actions, for example licence requirements, act as a barrier to entry. In addition, the existing companies may act against a new entrant for example by cutting prices in order to keep it out of the market.³³

Threat of substitutes: If there are possible substitutes for the product the threat of competition from substitutes is higher. The following factors are included in the threat of substitutes:

- buyers propensity to change,
- relative price performance of the substitutes.

The buyers' propensity to change means the willingness of the buyer to change to another product fulfilling his/her needs if such products are available. The relative price performance of the substitutes reflects the quality and price relation of the substitutes and how willing the buyer is to change, for example how much cheaper the train tickets should be in order to be seen as a competitive alternative to faster flights.³⁴

Power of the buyer is determined by the following factors:

- price sensitivity of the customers,
 - cost of the product relative to the total cost,
 - product differentiation,
 - competition among the customers,
- bargaining power of the customers,
 - size and concentration of buyer relative to supplier,
 - cost of changing to another producer,
 - amount of information of the buyer,
 - buyers' ability to start to produce the product itself, i.e. ability for backward integration.

The cost of the product relative to the total cost means how big part of the total costs that the buyer faces the product in concern covers. If it is a large, part the buyer is more sensitive to the price. On the other hand, if the product is important for the quality of the purchaser's

³³ Grant, Robert M., *Contemporary Strategy Analysis* (1998) p. 58 - 60.

³⁴ Grant, Robert M., *Contemporary Strategy Analysis* (1998) p. 57 – 58.

product, the purchaser is then less sensitive to the price. Furthermore, if the products are not different from each other the customer may be more willing to change to another product if the price increases. This indicates that the buyer has power. If there is a lot of competition among buyers the suppliers have a pressure for lower prices, higher quality and faster delivery. In addition, if the size of the purchaser and the amount that is normally purchased is large, the cost may be high if the customer is lost, which gives some power to the purchaser. Furthermore, with better and more knowledge about the suppliers and their prices and costs the buyers have higher bargaining power. Moreover, possibility for the purchaser to start to produce the product itself affects the power of they buyer.³⁵

Power of supplier include factors which determine the power of supplier in relation to the producer and the power depends on the same issues as the bargaining power of buyer³⁶.

2.4. Framework for the Analysis of Strategic Trade Policy of States Regarding to Subsidies

In the lack of perfect competition, according to economists Barbara Spencer and James Brander of University of British Columbia, a government intervention may be justified due to a market failure. In an industry, where there are only a few companies in effective competition the perfect competition approach is not applicable. In such a market, there will be excess returns meaning that the companies will make more profits than in another similar risk industry with more perfect competition. Thus, there will be an international competition over the excess profit. In this kind of situation a government may intervene so that the excess profit is directed to a domestic company. Actually, in a simplest case, a subsidy granted to the domestic company affecting negatively investment and production of foreign competitors, may increase the profits of the domestic company more than the initial subsidy was. Thus, making the subsidy to be beneficial. In a case in which the company is only exporting, the excess profit gained from foreign competitors would increase national income at the expense of other countries.³⁷

On the other hand, a situation, in which the other company has a special, underlying advantage, for example better technology, the company receiving subsidies may be able to

³⁵ Grant, Robert M., *Contemporary Strategy Analysis* (1998) p. 58, 63 - 64.

³⁶ Grant, Robert M., *Contemporary Strategy Analysis* (1998) p. 64.

³⁷ Krugman, Paul R. & Obstfeld Maurice, *International Economics: Theory and Policy* (2000) p. 281 - 283.

make profits but not in excess of the amount of the subsidy. This could be, because of the special knowledge of the other company gives a competitive advantage to it. In such situation, the subsidy has failed to act and is not successful.³⁸

This theory indicates that in certain situations state aid would be beneficial and in other occasions it would not. Thus, sometimes the aid of the government could create excess profits over the amount of the subsidy, and hence, it would look as a good strategy option for governments in certain situations.³⁹

However, this theory has received critics. This theory has raised questions concerning whether it is possible to get enough information that this theory could be used effectively. Moreover, in a real life the industries cannot be looked at in isolation, because if subsidies are granted to one industry it will draw resources from other industries and increase costs in those other industries. Moreover, the policy of a government to grant subsidies may lead to an increased risk of trade war, which could eventually leave to situation that every party loses. Furthermore, this theory does not take into account the customers, and how it affects them.⁴⁰ However, although this theory may not be very useful as a strategic tool to decide whether the government should, when it is legally possible, grant a subsidy or not, this theory could be useful in explaining why some current state aids are beneficial and why some are not.

2.5 Summary of the Framework

In this chapter I have introduced the legislation and the theories that are used in this study. The main legal framework of this work is Article 296 EC. It recognizes the special nature of the hard-defence sector and gives the Member States more freedom to legislate and take actions they consider necessary in regards to the trade in hard-defence material. Another Article referred to in this study, although less, is Article 87 EC, which concerns state aid within the European Union. One Decision of the Commission of the European Union and one case from the European Court of First Instance are presented later in this thesis, in order to see, how Article 296 EC is applied in the European Union.

³⁸ Krugman, Paul R. & Obstfeld Maurice, *International Economics: Theory and Policy* (2000) p. 283 - 284.

³⁹ Krugman, Paul R. & Obstfeld Maurice, *International Economics: Theory and Policy* (2000) p. 283 - 284

⁴⁰ Krugman, Paul R. & Obstfeld Maurice, *International Economics: Theory and Policy* (2000) p. 283 - 285.

Porter's five forces framework is used in this thesis to introduce the industry and the factors that have a strong impact on the hard-defence sector and competition within the industry. I assume that the Member States have an important role in the industry. One of the ways that the Member States affect the industry is through state aid. The theory related to the impact of subsidies (Spencer-Brander –theory) is used in this study to see, how the governments of the Member States can affect the industry through state aid. Through Spencer-Brander –theory I will see what is the role of the government through subsidies in the industry.

At the end I will combine the findings of these three parts in order to be able to give a comprehensive answer for the problem of this thesis. Firstly, the industry analysis provides information about the hard-defence industry and about the role of governments within the industry. Then, the analysis of the application of Article 296 EC reveals, how this Article is really applied in the European Union in a situation where state aid is granted. Then after studying the industry and application of Article 296 EC the role of the state aid in the hard-defence sector is studied. The first two parts give important background information in order to understand the role of and rationale behind the state aid.

3. Industry Analysis of the Hard-Defence Sector

In this part, I will use Porter's five forces framework to analyse the hard-defence material industry. Especially I will concentrate on the role of the governments as buyers, but also as having other roles. Firstly, I will analyse the situation in the sector through the other factors of Porter's five forces framework, i.e. I will go through the industry rivalry, threat of entry, threat of substitutes, and power of suppliers. Then I will go through the power of the buyer as well as concentrate more on the role of the government, which is as well referred to in other sections.

3.1. Industry Rivalry

According to the Porter's five forces framework of competition there are six factors, which are important in determining the nature and intensity of competition among already existing companies in the industry. As said before, these are the level of concentration, diversity of competitors, product differentiation, excess capacity and exit barriers as well as cost conditions of the industry⁴¹

First, I will say something about the structure of the industry. The big defence companies have often both military and civil businesses, although some of the companies operating on defence market concentrate only on defence equipment⁴². In addition, the arms production of major arms systems has concentrated in relatively few countries because of the high R&D costs financed by governments. This concentration has borne from the will to utilize economies of scale and lower the unit costs.⁴³

So, in Europe the manufacturing of defence equipment has concentrated in certain countries. The main countries are the United Kingdom, France as well as Germany. Those countries with Italy, Spain and Sweden cover over 90 % of Europe's defence industrial capabilities. They also spent the most in defence in the European Union (85 % of the EU's

⁴¹ Grant, Robert M., *Contemporary Strategy Analysis* (1998), p. 61 - 63.

⁴² Hartley, Keith, *Defence Economics and the Industrial Base* p. 7.

⁴³ Dunne, J. Paul, Garcia-Alonsa, Maria, Levine, Paul, Smith, Ron, *Concentration in the International Arms Industry* (2002) p. 1 - 2.

defence spending) as well as in R&D in the European Union (98 % of the R&D expenditures in the EU).⁴⁴

However, although most of the defence industry in Europe has concentrated in certain countries the armament sector in Europe is still quite fragmented into national markets and there is duplication, which is costly, in all areas related to armament, i.e. procurement bureaucracies, research activities, industrial capacities and defence programmes in Europe. This is for example because the arms producer countries, among themselves, as well as with non-arms producers have different procurement and market policies.⁴⁵ Thus, while other industries became globalised and went multinational the arms industry stayed quite national due to the preference of governments, the customers, to buy from domestic companies. So, the large countries able to manufacture relied on domestic industry. Smaller countries, unable to finance high R&D costs imported the large weapon systems.⁴⁶

The demand of defence material has decreased, for example due to the lower defence budgets. Due to for example the lower budgets, the larger countries started to have problems to support the domestic industry as well, which made them to be more open for imports. This has led to the fact that domestic and foreign weapons started to be closer substitutes for each other than in the past, which then has led to increased competition. It has, as well, affected the level of concentration.⁴⁷

So, competitiveness has become more important for the defence companies and they are following the civil global companies by seeking markets throughout the world and seeking suppliers in other countries with lowest price. Traditionally, these companies have been operating on the national market and supplied only with the national armed forces. However, now also defence companies are looking for economies of scale and scope and reduction of unit fixed costs through higher volume of products. Also governments are more and more willing to shop around and look for the lowest price and are not so protective towards the military industry of their countries.⁴⁸

The following table shows the evolution of the industry between 1990 and 1998⁴⁹.

⁴⁴ Schmitt, Burkard, *The European Union and Armaments, Getting a Bigger Bang for the Euro* (2003) p. 10.

⁴⁵ Schmitt, Burkard, *The European Union and Armaments, Getting a Bigger Bang for the Euro* (2003) p. 10.

⁴⁶ Dunne, J. Paul, Garcia-Alonsa, Maria, Levine, Paul, Smith, Ron, *Concentration in the International Arms Industry* (2002) p. 1 - 2.

⁴⁷ Dunne, J. Paul, Garcia-Alonsa, Maria, Levine, Paul, Smith, Ron, *Concentration in the International Arms Industry* (2002) p. 1 - 2.

⁴⁸ Hartley, Keith, *Defence Economics and the Industrial Base*, p. 7 - 8.

⁴⁹ Dunne, J. Paul, Garcia-Alonsa, Maria, Levine, Paul, Smith, Ron, *Concentration in the International Arms Industry* (2002) p. 4.

Table 1. The Defence Industry 1990-1998.

	1990			1998		
	All	US	non-US	All	US	non-US
No. of companies	123	51	72	104	39	65
Concentration ratio:						
5 companies	22	35	33	41	66	40
10 companies	36	56	50	55	82	56
20 companies	55	78	68	70	93	72

Source: Dunne, J. P., Garcia-Alonsa, M., Levine, P., Smith, R. (2002).⁵⁰

As it can be seen from the table above, the industry has become more concentrated in 1998 compared to 1990. In 1990 the five biggest companies covered 22 % of the global arms production. In 1998 the five biggest covered already 41 %. The submarkets, the US and non-US markets, are, as well, concentrated. However, the concentration, as it can be seen from the table, has been stronger in the United States.⁵¹ The most of the companies exist there as well. However, in order to stay competitive, for example European companies have started to merge. Thus, there starts to be smaller number of larger companies in Europe as well, which increases concentration.⁵²

The technical advancement has resulted to new products, and has also changed the structure of the defence industry. In addition, the cost of defence equipment has increased and the costs are expected to increase more in the future.⁵³ Actually, by its nature, the major weapons systems sector could be thought to be a very concentrated market like civil airlines sector. However, the impact of national governments and their will to have domestic defence industry has hindered the increase of the concentration.⁵⁴

Furthermore, due to the decreased defence budgets, the demand has decreased, and the companies are not doing so good. Thus, the costly duplication and market fragmentation is not good, if the European countries want to maintain a competitive European Defence Industrial and Technological Base (EDITB)⁵⁵. Currently, the national markets are too small to

⁵⁰ Dunne, J. Paul, Garcia-Alonsa, Maria, Levine, Paul, Smith, Ron, *Concentration in the International Arms Industry* (2002) p. 4.

⁵¹ Dunne, J. Paul, Garcia-Alonsa, Maria, Levine, Paul, Smith, Ron, *Concentration in the International Arms Industry* (2002) p. 5 – 6.

⁵² Hartley, Keith, *Defence Economics and the Industry Base*, p. 8.

⁵³ Hartley, Keith, *Defence Economics and the Industrial Base*, p.4.

⁵⁴ Dunne, J. Paul, Garcia-Alonsa, Maria, Levine, Paul, Smith, Ron, *Concentration in the International Arms Industry* (2002) p. 6.

⁵⁵ Schmitt, Burkard, *The European Union and Armaments, Getting a Bigger Bang for the Euro* (2003) p. 12.

support the national industry and to provide adequate economies of scale⁵⁶. Furthermore, it has been argued that there is excess capacity in the arms sector⁵⁷.

The products of different companies concentrating on similar armaments (for example on naval vessels or fighter aircraft) can be substitutes to each other and there is probably product differentiation due to the different R&D programmes. However, the industry is not operating so efficiently and the companies are not able to compete so freely with their products and special knowhow, because the governments have a strong impact. This is, however, changing and the level of competition has increased, but the governments still, through different policies, affect the trade and competition. Thus, the governments have an impact on rivalry between existing companies. However, the next quotation could suggest that the change is on its way:

“...EADS had won preferred-bidder status for a £13bn (\$23.6.bn) contract to provide air-to-air refueling aircraft for the UK was an important milestone for a Franco-German company wanting to expand its military business in the largest defence market in Europe.

Not only did it beat a consortium led by hometown favourite BAE Systems, but it is the second time in as many years it has won a UK defence contract in a straight competition with its British rival.”⁵⁸

As it has been stated before, the governments play a role as buyers and can affect the industry and competition within the industry either preferring domestic companies or having fair bidding competitions when purchasing. They can affect the industry as investors and legislators as well. The role of governments is studied more in the chapter related to power of buyer and the role of the governments.

3.2. Threat of Entry

According to Porter’s five forces framework one of the factors affecting competition in the industry is the threat of entry of possible new competitors. Especially if the industry makes

⁵⁶ Schmitt, Burkard, *The European Union and Armaments, Getting a Bigger Bang for the Euro* (2003) p. 15.

⁵⁷ Levine, Paul & Smith, Ron, *The arms trade – winners and losers* (1997) p. 346.

⁵⁸ Spiegel, Peter & Odell, Mark, *EADS milestone in UK refueling deal* (2004) p. 17.

profits and thus earns a return on capital above the cost of capital, other companies would be interested in to enter the market. So, if there are no barriers to entry, the profit level of the industry should be on competitive level. In most of the industries the barriers to entry exist and new companies are not able to enter the field on equal terms with the companies already existing in the sector. There are different kinds of barriers to entry, for example capital requirement, governmental or legal barriers and economies of scale, as mentioned before.⁵⁹

Entry by new companies is difficult into the hard-defence market because of the high costs due to the technology and R&D requirements. The defence equipment is becoming more and more complex and they are becoming costly to produce and purchase due to higher development and unit production costs. Thus, in addition to lower defence budget these higher costs lead to the fact that less equipment (for example aircrafts) is purchased. On the other hand, these new equipment are seen more productive (effective) thus leading to the fact that fewer of them is needed. Thus, the unit costs are becoming higher because the quantity to be purchased is getting lower and because of the amount of technological knowledge needed has increased and got more expensive.⁶⁰ The high R&D costs cannot be spread over a large volume purchased when the amount is low. This affects the competitiveness of the companies. At the same time, it works as a barrier to entry.

In addition, the high need for economies of scale functions as a barrier to entry. Industries that require for example high capital or lot of research require large-scale operation. A new entrant faces a problem when entering. It has to decide whether to enter as a small unit while it will face high unit costs or entering as large, when there is a risk that the capacity of the company is underutilized while it tries to increase sales volume.⁶¹ In the defence industry in Europe the companies have merged so that they could compete with large US companies⁶². The trend has been that there are fewer but larger companies operating in this field⁶³.

Furthermore, the strong R&D orientation of the industry creates absolute cost advantages for the existing companies through economies of learning. The existing companies have more knowledge and experience, which are important in the industry. This is as well one of the entry barriers.

⁵⁹ Grant, Robert M., *Contemporary Strategy Analysis* (1998) p. 59.

⁶⁰ Hartley, Keith, *Defence Economics and the Industrial Base*, p. 4.

⁶¹ Grant, Robert M., *Contemporary Strategy Analysis* (1998) p. 59.

⁶² Hartley, Keith, *Defence Economics and the Industrial Base*, p. 8.

⁶³ Hartley, Keith, *Defence Economics and the Industrial Base*, p. 4.

In addition, there are more restrictions introduced by the governments of the Member States as well as from the European Union concerning the trade and exports of hard- and soft-military equipment than on exports of normal goods⁶⁴. This can be also seen as a barrier.

3.3. Threat of Substitutes

According to Porter's five forces framework the threat of substitutes means the propensity of the buyer to change to another product fulfilling the needs if the price increases. The price that the customer is ready to pay on the product depends on the availability of the substitutes. If there is no substitutes the demand is inelastic with respect to price, and thus the price increase does not so easily make the customer to abandon the product.⁶⁵ Due to the special nature of the hard-defence material, there is no substitute for hard-defence and military material outside the industry.

3.4. Power of Supplier

Bargaining power of supplier includes the same factors as the bargaining power of buyers. The power includes factors such as the buyers' sensitivity to the price, which depends on the importance of the product as well as the level of possible substitutes. In addition, the relative bargaining power of the buyer including factors such as size and ability for vertical integration of the buyer. Because raw materials, semi-finished products, and components are normally supplied by small companies to larger manufacturers, they normally do not have very strong bargaining power.⁶⁶

The studies concerning defence industries concentrate normally on the major prime contractors and their close supplier companies. Actually, little is known about the supply chain of defence companies, "for example the technical capabilities of subcontractors, their location, their dependence on defence business and their importance in local labour

⁶⁴ There are, for example, different licenses for firms, import/export licenses etc, which affect the trade and exports of the equipment and make it time-consuming. (COM (2003) 113, p. 13 – 16).

⁶⁵ Grant. Robert M., *Contemporary Strategy Analysis* (1998) p. 57.

⁶⁶ Grant. Robert M., *Contemporary Strategy Analysis* (1998) p.63 - 64.

markets.”⁶⁷ Suppliers can be small component suppliers or other defence companies or high tech companies. They can have a cooperation contract together or they can just buy components when needed. The bargaining power of the supplier depends on the importance of the product and on the level of competition among the suppliers.

3.5. Power of Buyer and the Role of the Governments

As it was stated before, according to Porter’s five forces framework the bargaining power of buyer depends on buyer’s price sensitivity, which is affected by the importance of the products, by the existence of similar products, by the competition of the companies, as well as by the importance of the product to the quality of the buyer’s product. Also relative bargaining power, including factors such as the size and concentration of the buyer compared to the suppliers, the amount of information of the buyer, and buyer’s ability to integrate vertically and start to produce the product itself.⁶⁸

As having a role as a buyer the governments have the most direct impact on conditions of demand of many goods and services. For example governmental organisations are the main buyers in defence equipment industry, as well as in industries related to infrastructure (e.g. state-owned airlines and electric utilities).⁶⁹

Government procurement can be beneficial but it may also be not beneficial for the national competitive advantage. When it happens too often, it may work against it, because the government procurement may become a guaranteed market. Actually, there are in the USA as well as in other countries ‘buy domestic products’ laws or policies, which exclude foreign suppliers, affecting some procurement of the governments. In such situations the companies may see the government demand as a birthright for them and the companies may lobby the governments to have such product standards or regulations which would freeze the possible international rivals out.⁷⁰

So, what is the power of the buyer, the impact of the governments, on the hard-defence sector? First of all, the bargaining power of buyer in hard-defence material industry is high. This is due to many factors. Firstly, manufacturers normally have only one customer: the

⁶⁷ Hartley, Keith, *Defence Economics and the Industrial Base*, p. 5.

⁶⁸ Grant, Robert M., *Contemporary Strategy Analysis* (1998) p. 63 – 64.

⁶⁹ Porter, Michael E., *The Competitive Advantage of Nations* (1990) p. 644.

⁷⁰ Porter, Michael E., *The Competitive Advantage of Nations* (1990) p. 644 – 645.

national government. If exporting is possible, foreign governments may also be customers. Sometimes, however, the sales to foreign governments are restricted by the domestic government or legislation. Some countries in Europe have more restrict rules, e.g. Germany and the Netherlands, on exports than some others, e.g. the United Kingdom.⁷¹

The products are important for the buyers, the governments, for example the level of quality of the defence depends on the quality of the defence equipment. The products are often very expensive as well. However, the bargaining power of the government is strong, because of its strong relationship with and impact on the industry. Firstly, this can be seen in the legal framework covering hard-defence sector. The trade on hard-defence material, as stated before, is governed by the legislation of the Member States, not by the EC legislation.

Furthermore, special to this market is that still the assistance and aid; direct for example through subsidies and indirect through purchasing decisions, of governments is affecting the operations of the companies and the market. Thus, in order to understand the defence industry and the market, it is important to understand the role of the governments. They are major buyers and normally the only buyers of defence material. So, governments can affect the structure, the size and the ownership of national defence industry, as well as conduct and performance of the defence industry by for example using its buying power and by favouring non-price competition such as R&D. Governments, in order to maintain the domestic defence industry, can purchase the equipment for their need from domestic producers or they can grant direct subsidy payments to domestic defence industry. So, in this way the governments can affect, what the defence equipment produced within that country are.⁷² This is possible, if the material is such that it falls outside the EC legislation (is for military purposes) and thus is governed by national laws. Moreover, the decreased defence budgets have shifted the balance as well to the buyers⁷³. These factors can affect the competition in the common market, due to the fact, that more and more defence companies have trade across the borders as well.

So, as Mr. Liikanen, European Commissioner for Enterprise and Information Society, has stated, there are still many specific characteristics in defence industry when it is compared to civil industries. This is although more and more the defence industry is seen as a 'normal' industrial activity and it is, as all other industries, required to increase efficiency so that it

⁷¹ Trybus, Martin, *European Defence Procurement Law: International and National Procurement Systems as Models for a Liberalised Defence Procurement Market in Europe* (1999) p. 24.

⁷² Hartley, Keith, *Defence Economics and the Industrial Base*, p. 2 - 3.

⁷³ Walker William & Gummett Philip, *Nationalism, Internationalism and the European Defence Market* (1993).

creates value for money to its customers and protects the interests of shareholders of the defence equipment manufacturers. This special nature of the sector is mostly a result of the key role of the states, because the states are not only clients but also involved quite heavily in the financing of R&D and they also have a considerable role in strategic orientation.⁷⁴

As stated above, if the government has a policy to buy domestic products a company may see it as a birthright. It has been the situation in the hard-defence sector as well. The defence industry itself has not been, until recently, the driving force behind cooperation. And still, the companies, which are not competitive, are afraid of opening up of the armaments markets and at the same time the loss of protection of the state.⁷⁵

However, currently the industry itself is trying to increase its influence on evolution of the defence sector. Actually, nowadays, the restructuring of the sector is a lot a concern of private sector and the government are playing smaller role than a decade ago. For example, the industry is emphasizing the importance of cooperation within Europe.⁷⁶

3.6. Summary of the Industry Analysis

In this chapter the hard-defence industry as well as the main factors affecting competition within the industry was introduced. The hard-defence material sector in the European Union is not doing so well and the competition is affected quite a lot by the governments.

The hard-defence material industry is concentrated in certain countries in Europe. However, the market is still quite fragmented. Traditionally the domestic defence companies were supplying national governments with armament. However, for example due to decreased defence budgets the companies have tried to look for economies of scale from foreign markets. In addition, the governments have started to be more willing to import products. So, the amount of competition has increased among the companies within the industry.

However, the industry is not as concentrated as it could be thought to be, when compared to other similar industries. In addition, there are at the moment excess capacity and duplication in the industry, although the situation is changing and, as said before, the industry

⁷⁴ Liikanen, Erkki, *The role of the EU and European Commission initiatives to promote a competitive European defence technological and industrial base* –speech (2000).

⁷⁵ Schmitt, Burkard, *The European Union and Armaments, Getting a Bigger Bang for Euro* (2003) p. 10.

⁷⁶ Guay, Terrence & Callum Robert, *The transformation and future prospects of Europe's defence industry* (2002) p. 771.

is becoming more concentrated. For example some mergers have happened between defence companies so that they would be able to compete and survive. Due to the bad situation of the European armaments industry it has been stated that “Europe have to develop much more efficient approach if it wants to equip its armed forces adequately and sustain a competitive European Defence Industrial and Technological Base (EDITB)”.⁷⁷

According to the analysis of the industry it seems that the governments of the Member States have a very strong impact on the competition in the hard-defence industry and on the structure of the industry in Europe. The protectionism of the domestic armaments industry still exist, although nowadays less, in the hard-defence sector in Europe. The Member States affect the operation of the companies within the hard-defence sector through different actions and policies. In addition, the different roles of the governments of the Member States affect impact of the governments in the industry. The governments may act as buyers, legislators and investors. The government’s have an impact also on barriers to entry through a legislation applied to hard-defence material. Moreover, as only buyers, they have also quite strong impact and power as buyers.

The impact of the governments can be beneficial but as well non-beneficial. Due to the special nature of the industry and strong impact of governments, the governments of the Member States play a big role in many ways on the hard-defence sector. Although the governments can affect the industry in many ways, in this thesis the main focus is on governmental state aid.

In the next chapter the application of the legal framework of this thesis, Article 296 EC, is presented in situations where governments have granted state aid to domestic defence companies. This is to see, that in reality the state support for production of military equipment is acceptable in the European Union if the states view that it is necessary for the security of the nation. These cases are presented to clarify, how Article 296 EC is applied in the European Union. Then the fifth chapter includes an analysis of state aid in hard-defence sector and rationale for and against the state aid in hard-defence sector in Europe.

⁷⁷ Schmitt, Burkard, *The European Union and Armaments: Getting a Bigger Bang for the Euro* (2003) p. 12.

4. State Aid and Application of Article 296 EC in the EU

Due to the special nature of the sector and due to the close relationship with the national governments, the defence sector may directly or indirectly benefit from public support in a form of state aid⁷⁸. Member States have defined the scope of Article 296 EC and the security interests of nations very widely, so that they have been able to avoid the application of the EC legislation in the field of armaments⁷⁹.

The governments of the Member States in the European Union support their national defence industries with different kinds of aids. These benefits may distort competition as well as impact the trade between the Member States. The trade on arms material can be distorted for example because the companies receiving aid are competing with companies from other Member States. This is also in situations, in which the company receiving aid is not exporting.⁸⁰

However, as it has been stated before aid for hard-defence material does not fall within the EC legislation, because it is exempted through Article 296 EC. However, there are many defence equipment companies, which are also producing civil goods. Thus, the aid granted to military manufacturing may affect the civil sector and thus, it may distort the competition in the civil sector. This has been a concern of the Commission and it has stated this issue in its Communication in 1996 (COM (96) 10 final). This has been seen as creating difficulties for the Commission in searching and proving of incompetence with Article 87 EC when it concerns companies manufacturing military and civil goods.⁸¹

Article 87 EC concerning state aid control has not been, at least yet, applied to situations concerning military equipment and in which Article 296 EC has been applied. However, state aid for defence production must not in any case adversely affect the competitive conditions in the common market on goods that are not manufactured for military purpose. This point of view is especially relevant in cases in which companies are manufacturing both military and non-military equipment. Thus, it is especially necessary to

⁷⁸ Communication of the Commission, COM (2003) 113 *European Defence – Industrial and Market Issues: Towards an EU Defence Equipment Policy* (2003) p. 14.

⁷⁹ Schmitt, Burkard, *The European Union and Armaments, Getting a Bigger Bang for the Euro* (2003) p. 9.

⁸⁰ Trybus, Martin, *European Defence Procurement Law: International and National Procurement Systems as Models for a Liberalised Defence Procurement Market in Europe* (1999) p. 92.

⁸¹ Trybus, Martin, *European Defence Procurement Law: International and National Procurement Systems as Models for a Liberalised Defence Procurement Market in Europe* (1999) p. 93.

make sure that there is no cross-subsidisation between these two activities within the company. Furthermore, the aid granted to non-specifically military products would fall within the regime of the Article concerning state aid.⁸²

4.1. Commission Decision: Lürssen Maritime Beteiligungen GmbH & KG

Although Article 87 EC has not been applied in a case of hard-defence material, there have been some cases related to it. In the Commission Decision 1999/763/EC of 17 March 1999 the Commission decided that the aid granted by Land Bremen, Germany, which Lürssen Maritime Beteiligungen GmbH & KG (later referred to as LMB) received through an acquisition, fall outside the regime of EC legislation because the measures fell within the regime of Article 296 EC⁸³.

In this case the company received from state Bremen aid for employing some of the employees of the acquired company Bremer Vulkan Marine Schiffbau GmbH (later referred to as BVM) as well as workers who were involved in naval shipbuilding employed by former Bremen Vulkan Werft GmbH. In addition, a state organisation waived claims as well as the interest on the loan given to BVM. Furthermore, the state Bremen had promised to grant aid for planned investments. These were seen by the Commission as different kind of state aid within the meaning of Article 92(1) EC (now Article 87(1) EC) and Article 1(d) of Council Directive 90/684/EEC of 21 December 1990 on aid to shipbuilding (seventh Directive).⁸⁴

Lürssen concentrates on naval shipbuilding but also sometimes on the construction of large yachts and commercial passenger ships. The acquired company BVM was engaged in the construction of the new frigate, the German F124 frigate programme, with two other companies, and this was the original reason to purchase the company.⁸⁵

Because the Commission deemed that the measures could be incompatible with the EC legislation it studied the case. Firstly, when the case was assessed by the Commission it was stated, because the measures granted and planned to be granted through state resources

⁸² Communication of the Commission, COM (2003) 113 *European Defence – Industrial and Market Issues: Towards an EU Defence Equipment Policy* (2003) p. 14.

⁸³ Commission Decision 1999/763/EC, 17 March 1999. *The measures, implemented and proposed, by the Federal State of Bremen, Germany, in favour of Lürssen Maritime Beteiligungen GmbH & Co. KG*, p. 1.

⁸⁴ Commission Decision 1999/763/EC, 17 March 1999. *The measures, implemented and proposed, by the Federal State of Bremen, Germany, in favour of Lürssen Maritime Beteiligungen GmbH & Co. KG*.

⁸⁵ Commission Decision 1999/763/EC, 17 March 1999. *The measures, implemented and proposed, by the Federal State of Bremen, Germany, in favour of Lürssen Maritime Beteiligungen GmbH & Co. KG*, p. 1 - 2.

favour one undertaking having business across the borders of member states and thus, give to that company financial support that other competing companies do not receive, the measures are to be considered as state aid within the meaning of Article 92(1) of the EC Treaty (now Article 87). The Commission noted that both the State of Germany as well as the both companies involved has stated that Article 223(1)(b) (now Article 296(1)(b)) should be applied to these measures. The Commission went through also all of the other arguments of the parties. In this case Germany emphasised that the ability to maintain a minimum capacity in naval shipbuilding is necessary to secure its essential security interests. The Commission was willing to accept the measures if they did not adversely affect competition in the common market on products which are not for military purposes.⁸⁶

After inquiry for clarification by the Commission, Germany confirming the fact that all the measures in question were related to the naval shipbuilding. The employees of whom the company got aid from the state were engaged in a non-naval shipbuilding assignment as well before the naval shipbuilding started. It was not seen affecting adversely the conditions of competition within the common market because the cost of keeping these employees while they were underemployed before the naval shipbuilding started, were higher than cost of having hired employees for the actual time period needed for the non-naval shipbuilding.⁸⁷

Furthermore, the waived loan was given before the acquisition to BVM, which is only engaged with naval shipbuilding. Thus, the measure does not adversely affect the competition in the common market regarding to products, which are not intended for military purposes.⁸⁸

Furthermore, Germany confirmed that no commercial shipbuilding would take place on the dock, to which the investment aid was planned to be granted and where the naval vessels as well as large yachts were meant to be built and repaired, before 31 December 2003. Possible commencement of commercial shipbuilding in this dock, after the before mentioned date, will be subject to the approval of the Commission. The investment aid was assessed also through Article 92(3)(c) (now 87(3)(c)) because also large yachts were build and repaired on this dock. These large yachts did not fall within the regime of seventh Directive. It was also

⁸⁶ Commission Decision 1999/763/EC, 17 March 1999. *The measures, implemented and proposed, by the Federal State of Bremen, Germany, in favour of Lürssen Maritime Beteiligungen GmbH & Co. KG*, p. 4 - 5.

⁸⁷ Commission Decision 1999/763/EC, 17 March 1999. *The measures, implemented and proposed, by the Federal State of Bremen, Germany, in favour of Lürssen Maritime Beteiligungen GmbH & Co. KG*, p. 5.

⁸⁸ Commission Decision 1999/763/EC, 17 March 1999. *The measures, implemented and proposed, by the Federal State of Bremen, Germany, in favour of Lürssen Maritime Beteiligungen GmbH & Co. KG*, p. 5.

found out that the planned investment aid was based on the regional aid scheme that was approved. Thus, the investment aid was found to be compatible with the EC legislation.⁸⁹

Finally, the Commission concluded that the financial measures taken and planned to be taken by the Federal State of Bremen, Germany, in favour of naval shipbuilding are such that are necessary for the protection of the essential interests of Germany's security as it is stated in Article 223(1)(b) (now Article 296(1)(b)) of the EC Treaty, and thus, the Article 92 and 93 (now Articles 87 and 88) of the EC Treaty cannot be applied. In addition, the investment aid was seen compatible with the requirements of the common market when it comes to Article 92(3)(c) of the Treaty (now 87(3)(c)).⁹⁰

4.2. Case Fiocchi Munizioni SpA

In the case T-26/01 the Court of First Instance had to deal with a question regarding to a state aid to a company operating on defence industry and other industries. In this case an Italian company, Fiocchi Munizioni SpA (later referred to as the Applicant), which is operating on the field of arms and munitions manufacturing and marketing, complained to the Commission about the subsidies granted from 1996 to 1998 to a Spanish arms production company Empresa Nacional Santa Barbara (later referred to as Santa Barbara) by the Kingdom of Spain. The Commission investigated the complaint and asked further information about subsidies from the Spanish authorities. The Spanish authorities answered the letters and gave further information. The Commission viewed the issue being more about the application of Article 296 EC and whether it has been applied inappropriately and whether the Commission should take further actions as made possible in Article 298 EC. However, the Applicant thought that the Commission was not operating effectively in order to reach the decision, and thus, the Applicant referred to the European Court of First Instance blaming the Commission for a failure to act.⁹¹

This case is more about the procedure when the Commission was investigating the complaint in the first place and whether the Commission failed to act, but there are some

⁸⁹ Commission Decision 1999/763/EC, 17 March 1999. *The measures, implemented and proposed, by the Federal State of Bremen, Germany, in favour of Lürssen Maritime Beteiligungen GmbH & Co. KG*, p. 5 - 6.

⁹⁰ Commission Decision 1999/763/EC, 17 March 1999. *The measures, implemented and proposed, by the Federal State of Bremen, Germany, in favour of Lürssen Maritime Beteiligungen GmbH & Co. KG*, p. 6.

⁹¹ Case T-26/01, *Fiocchi Munizioni SpA v. Commission of the European Communities*.

interesting points about the application of Article 296 EC in an occasion of state aid. Thus, in the following paragraphs I will concentrate on what was said in the judgment about the application of Article 296 EC and not concentrate on the case as such, as it is not so relevant for this study as a whole case.

4.2.1. Arguments of the Applicant

The Applicant claimed that the subsidies given to Santa Barbara does not fall within the regime of Article 296(1)(b) EC because it, as also the Applicant, operates in the international markets and takes part in the public invitations to tender for the supply of munitions. Thus, the aid given cannot be seen as necessary in order to protect the essential interests of the security of the Kingdom of Spain as the abovementioned Article provides.⁹²

In this case the Applicant referred to the Commission decision 1999/763/EC of 17 March 1999 concerning the subsidies granted to Lürssen Maritime Beteiligungen GmbH & Co. KG (the decision handled above) and to the fact that in this Lürssen case the Commission had viewed that it is necessary to find out whether the case falls within the regime of Article 296 EC and whether the subsidies granted are really intended only for the products of a specifically military nature. The Applicant felt that in this decision, contradictory to the current case, it was not enough that the Member State invoked that it falls within this Article.⁹³

The Applicant continued that the products of Santa Barbara are for both military and civil purposes. In addition, it stated that in order to fall within the Article 296 EC the products should be intended solely for the domestic market, so that the essential interest of the national safety can be protected. In this case, however, Santa Barbara had after receiving the aid from the Spanish authorities taken part in the tendering competition for the supply of armaments in other Member States. Thus, the Applicant claims that the business of this undertaking cannot be viewed as being limited to products intended for specifically military purposes as said in Article 296 EC.⁹⁴

Furthermore, the Applicant complained that the subsidies helped Santa Barbara to trade aggressively in exports of armaments for military use but also for civilian use. The

⁹² Case T-26/01, *Fiocchi Munizioni SpA v. Commission of the European Communities*, point 12.

⁹³ Case T-26/01, *Fiocchi Munizioni SpA v. Commission of the European Communities*, point 53.

⁹⁴ Case T-26/01, *Fiocchi Munizioni SpA v. Commission of the European Communities* point 52.

Applicant claimed that the subsidies were the reason that Santa Barbara was able to participate in invitations to tender in other countries as well and thus, also was awarded a contract in Italy to supply the Italy with NATO parabellum 9 mm calibre cartridges.⁹⁵

4.2.2. Findings of the Court

The findings of the Court concerning to Article 296 EC and this case were as follows. Firstly, the Court stated that the treatment of the production of and trade in arms, munitions and war material is special and through Article 296 EC it is not prohibited for Member States to commit such activities and to have such measures, including actions affecting competition rules of the European Union, which are seen by that country necessary for the protection of its essential interest of its security.⁹⁶

Furthermore, the Court continued that the arms, munitions and war material falling under the regime of this Article are listed by the Council on 15 April 1958 and this is mentioned in Article 296(2) EC. Thus, in such situation, where it is about the products listed by the Council and it is considered to be essential to protect the interest of the internal security, the state is not obliged to even notify the Commission of the state aid at the draft state, and the Commission cannot in such situation use the examination procedure of Article 88. The Article 296 EC is not applicable to other products or activities than the military products listed by the Council on 15 April 1958.⁹⁷ In Lürssen case the Commission was applying Article 88 EC and it did not open a bilateral examination made possible by Article 298 EC. In this current case, however, the Commission decided to open the bilateral examination under Article 298 EC.⁹⁸

In this case the Court explained the application of Article 296 EC and 298 EC. It stated that there are two specific legal remedies stated in the Treaty concerning the measures adopted by a Member State under Article 296(1)(b) EC. First of all, it is stated in the Article 296(1)(b) that measures must not adversely affect the conditions of competition in the common market as regards to products that are not intended for specifically military purposes. In such situation that these measures distort the conditions of the competition in the common

⁹⁵ Case T-26/01, *Fiocchi Munizioni SpA v. Commission of the European Communities* point 88.

⁹⁶ Case T-26/01, *Fiocchi Munizioni SpA v. Commission of the European Communities* point 57.

⁹⁷ Case T-26/01, *Fiocchi Munizioni SpA v. Commission of the European Communities* point 57 – 59.

⁹⁸ Case T-26/01, *Fiocchi Munizioni SpA v. Commission of the European Communities* point 75.

market, according to Article 298 EC, the Commission shall together with the particular state examine, what to do to adjust the measures to meet the rules of the Treaty. In the second paragraph of Article 298 EC the Commission as well as another Member State can bring the matter before the Court of Justice if it views that another Member State is improperly using Article 296 EC.⁹⁹

4.3. Discussion about the Cases

Firstly, the problem of the law of the first case can be stated as: Was an essential interest of the security of the state in concern, so that the measures taken fall under Article 296 EC and under the national law of the state? Another part of the problem of law could be stated as: Do the measures adversely affect the conditions of competition of products, which are not specifically intended for military purposes?

This case concerns different kinds of state aid regimes. There were direct subsidies as well as state aid through a forgiven loan. In this case the power of the Article 296 EC could be seen. The Commission deemed the measures as being state aid that affect the trade between the Member States. However, after receiving further information and rationale from Germany, it was seen that the security of the nation is in concern. Thus, it was concluded that the measure fall under the regime of Article 296 EC and thus, falls outside of the governance of the EC legislation. The investment aid was as well seen to be compatible with the EC legislation. The aid for employing the workers who were engaged in building non-military vessels as well while waiting for the naval vessel shipbuilding to get started, was seen not to affect adversely the conditions of competition in the common market, because the other option to have employees would have been cheaper. Thus, the company did not get extra gain from that aid and the competition within the common market regarding other products but military products was not affected adversely.

In addition, it was shown in the second case that the Member States are allowed to give subsidies to the arm manufacturing but it must not hinder the trade between the Member States in other products but in those that are stated in the list of the Council. This case is more about the validity of the actions of the Commission not about the subsidies. The Court found

⁹⁹ Case T-26/01, *Fiocchi Munizioni SpA v. Commission of the European Communities* point 61 - 64.

that when the Applicant raised the action for failure to act, the Commission had defined its position¹⁰⁰. Thus, it could be seen that the Commission did not act in a wrong way. The Commission had decided to open the bilateral examination made possible by Article 298 EC and thus, the Commission was not going to adopt a decision about the lawfulness of the subsidies¹⁰¹. Furthermore, if the Commission after bilateral investigation would think that Article 296 EC was applied improperly, the Commission could take the matter before the Court of Justice¹⁰². So, because the measure falls within Article 296 and 298 EC the EC legislation concerning state aid was not applied. Furthermore, the Applicant claimed that the aid adversely affected the conditions of competition of products that are not specifically intended for military purposes, but it did not try to prove it. The Applicant only referred to the competition of products intended for military purposes¹⁰³.

These two examples prove the power of Article 296 EC. As it was stated earlier, if the party is able to argue that the measures fall under Article 296 EC, the EC legislation is not applied to the case. However, as it was stated, if it is seen that the measures adversely affect the conditions of competition of other products that are not specifically intended for military purposes in the common market, the Commission shall with the particular state look for solution how to adjust the measures to be in accordance with the Treaty.

Furthermore, these both cases concern a situation in which a state has been behind the actions, which might be considered to be contrary to the competition legislation of the European Union. As it has been mentioned before, according to Commission's opinion Article 296 EC can be invoked by the states not companies¹⁰⁴. Thus, in these cases the measures can fall outside the EC legislation.

In the first case the Commission was studying whether the state aid is contradictory to the EC legislation concerning state aid. Germany defended itself by claiming that the state aid is necessary to protect the security of the state. The Commission after the investigation found it to be true. In the second case, the Applicant was complaining that the aid distorts competition. When the Commission investigated it, it saw that the question was more about whether Article 296 EC was used improperly. Thus, the Commission did not reach a decision

¹⁰⁰ Case T-26/01, *Fiocchi Munizioni SpA v. Commission of the European Communities* point 91.

¹⁰¹ Case T-26/01, *Fiocchi Munizioni SpA v. Commission of the European Communities* point 69, 73.

¹⁰² Case T-26/01, *Fiocchi Munizioni SpA v. Commission of the European Communities* point 78.

¹⁰³ Case T-26/01, *Fiocchi Munizioni SpA v. Commission of the European Communities* point 88 - 89.

¹⁰⁴ Trybus, Martin, *European Defence Procurement Law: International and National Procurement Systems as Models for a Liberalised Defence Procurement Market in Europe* (1999) p. 81.

concerning the lawfulness of the aid. Both cases, however, show that the states are allowed to give state aid to companies producing products intended for military purposes.

4.4. Summary of the Application of Article 296 EC in Regards to State Aid

Due to Article 296 EC the Member States are allowed to grant state aid to hard-defence material companies if they consider that it is necessary in order to protect the essential interest of the security of the nation. Thus, state aid, which might be considered to be contrary to the state aid legislation of the European Union if it was given to a company operating in another industry, can be given to a company operating on hard-defence material sector. This state aid may distort the competition and adversely affect the trade between Member States.

These two cases covered in this chapter present, how Article 296 EC is applied in the European Union. The decision of the Commission of the European Union as well as the case of the European Court of First Instance follow the legal framework for hard-defence material sector introduced earlier in this thesis. So, if Article 296 EC can be applied the state aid measures may affect the competition in or the trade between the Member States and it cannot be seen as being contrary to Article 87 EC. This is, because the measures fall within the legislation of the Member States due to the fact that the measures are seen necessary for the protection of the security of the Member State. However, if the measures are seen to adversely affect the competition on other products but products especially intended for military purposes on the common market, the Commission can with the particular Member State to look for a solution how to change and adjust the measures.

These cases reveal, once again, the strong role of the governments of the Member States in the hard-defence material sector in the European Union. They present how Article 296 EC is applied in the European Union in the case of state aid. However, as it is known, the hard-defence companies in Europe are not doing so good. So, the questions are; is this kind of legislation and application of the legislation necessary within the European Union? Is this legislation and application of the legislation beneficial to the companies operating on the hard-defence material sector? The next chapter includes the analysis of state aid in hard-defence material sector as well as arguments for and against state aid.

5. Analysis of State Support on Hard-Defence Material Sector

It may possibly be that the most important way of states to distort trade is through state aid¹⁰⁵. Actually, politicians may be willing to subsidise for example failing firms in order to decrease unemployment. Even in situations, in which the inefficiency could lead to higher unemployment in the long run. This could happen for example because of the need to increase taxes so that the aid can be paid as well as due to the loss of work to foreign companies after the reduction of the state aid.¹⁰⁶

The governments have used direct subsidies to companies as a tool to try to have an impact on factor cost as well as in otherwise shape competitive advantage. Almost every state grants subsidies to at least some industries aiming to enhance the situation in a favour of that particular nation.¹⁰⁷ However, “subsidy is rarely associated with true competitive advantage.”¹⁰⁸ It is seen to create an attitude of dependence and that a government support makes it difficult to get the industry to make investment and take risks without the support of the government.¹⁰⁹

5.1. Effects of the Strategic Trade Policy of States Regarding to Subsidies

The competition is not perfect in hard-defence material sector but imperfect¹¹⁰. According to Spencer-Brander theory related to imperfect competition and government intervention, when there is imperfect competition there is more probably excess profit opportunities than in the industry where there is more perfect competition. Thus, there could be international competition over the excess profits and the governments may be willing to intervene in order to domestic companies to get the excess profit.¹¹¹

¹⁰⁵ Korah, Valentine, *An Introductory Guide to EC Competition Law and Practice* (2000) p. 152.

¹⁰⁶ Korah, Valentine, *An Introductory Guide to EC Competition Law and Practice* (2000) p. 152.

¹⁰⁷ Porter, Michael E., *The Competitive Advantage of Nations* (1990) p. 639 - 640.

¹⁰⁸ Porter, Michael E., *The Competitive Advantage of Nations* (1990) p. 640.

¹⁰⁹ Porter, Michael E., *The Competitive Advantage of Nations* (1990) p. 640.

¹¹⁰ To have perfect competition there should be many buyers and sellers in the market, there should be freedom of entry and exit into the market, the buyers and sellers should have perfect knowledge, and all of the companies should produce homogenous products (Revision Guru, <http://www.revisionguru.co.uk/economics/perfcomp.htm>, 22.4.2004.)

¹¹¹ Krugman, Paul R. & Obstfeld Maurice, *International Economics: Theory and Policy* (2000) p. 281 – 282.

Due to the special nature of the defence industry the governments may have different reasons from the excess profit to intervene, for example the will to maintain domestic defence material production. However, the study of imperfect competition and government intervention of Spencer and Brander can be applied to this industry as well to see, how the state aid affects the industry and can be beneficial as well as non-beneficial.

As it was stated before, the hard-defence material industry has become more concentrated but it is not as concentrated as it could be when compared to other similar industries. It may be that many companies exist, not because they are doing good and are profitable themselves, but because of the aid and support from the domestic governments.

In the following paragraphs I will go through an example¹¹² of Brander-Spencer analysis regarding the possible consequences of subsidies. In this example, there are only two companies, X and Y, from different countries competing on a field of a new product. In this example, for simplicity, both companies can make only a yes/no decision to produce or not.¹¹³

Firstly, it is assumed that either of the companies can make profits making the product if it was the only producer, but if both companies produce, both will make losses. Thus, the firm who gets into the market first will get the profits, because the other company will view the situation to be such that there is no incentive to enter the market. However, according to Brander and Spencer, the government of the company willing to enter the market later may change the situation. If the government grants a subsidy for the company to enter the market later, then it might be that it would be profitable for that company to produce instead of the company who entered the market first. This is because the first company should then compete with the second company who gets subsidies. In this case, the government subsidy has overcome the advantage created by being the first in the market. Actually, the subsidy could increase the profit of the company more than the amount of subsidy is. Thus, the subsidy would be beneficial.¹¹⁴

This example would support the subsidies as a good strategy, because the subsidy granted increases the profits of the domestic company at the expense of a foreign company. If the interest of consumers is left out, this seems to increase the welfare in that country. However, what would be the answer of the government of the state of the other company? Due to this question among others this theory has got criticism due to the fact that a practical

¹¹² This example follows the example of application of Brander-Spencer analysis in the Krugman and Obstfeld's book *International Economics: Theory and Policy*.

¹¹³ Krugman, Paul R. & Obstfeld Maurice, *International Economics: Theory and Policy* (2000) p. 282.

¹¹⁴ Krugman, Paul R. & Obstfeld Maurice, *International Economics: Theory and Policy* (2000) p. 282 - 283.

use of it would require more information than it is likely to be available. In real life, it would be difficult to a government to know how the subsidies affect the industry and the state of competition. If it views the situation wrong, the subsidy may be a costly misjudgement.¹¹⁵

This could be the situation in a case that the first company in the market has some kind of underlying advantage, for example a better technology. So that when the other company enters the market, this company with the advantage would still be able to operate and create profits. On the other hand, the company with no underlying advantage would not be able to continue producing profitably if the other company with better technology enters the market. So in the case of no subsidies the company with the better technology would produce and the other company would not. Then, if the government of the second company with no underlying advantage grants a subsidy to it, which would be enough to induce it to produce, it may be that both companies make profits, but the profits of the company receiving a subsidy may be lower than the subsidy is. Thus, in such a case the subsidy is not successful and has failed to act.¹¹⁶

So, the subsidies may be beneficial in some situations but in other situations they are not. It is good to keep in mind, as stated before, that this theory has been criticised for example from the point of view of information availability. Is it possible to get enough information to use this theory effectively? In addition, the other industries and impact on them is not taken into account. Moreover, it is difficult to know, how the other governments will react.¹¹⁷ However, although criticised, and although this theory does not give a certain way to know, when it is good to grant subsidies and when it is not, this theory indicates that the subsidy can be beneficial in certain situations and certain situations it is not. This is the case in defence sector as well. Some state aid is seen to be not good for the trade and competition within the industry but on the other hand, some aid is seen to be needed.

5.2. State Aid in Hard-Defence Material Sector

It has been argued that the real economic return on arms exports could be negative and the amount of implicit subsidies given in the sector supports this view. In addition, it has been

¹¹⁵ Krugman, Paul R. & Obstfeld Maurice, *International Economics: Theory and Policy* (2000) p. 283.

¹¹⁶ Krugman, Paul R. & Obstfeld Maurice, *International Economics: Theory and Policy* (2000) p. 283 - 284.

¹¹⁷ Krugman, Paul R. & Obstfeld Maurice, *International Economics: Theory and Policy* (2000) p. 284 - 285.

claimed that the current state of the arms industry and market supports this view. This is, because the demand is falling and there is excess capacity in the arms sector, and these factors lower the prices and profitability. The amount of competition has increased and the support of the governments for bids has become in the last few years more lavish. This is to keep national defence companies in the market. So, the government of the selling company may subsidise the buyer quite heavily as well. Thus, it is not easy to know, whether the national economic return on the sales of domestic companies is positive. This does not hold in sectors, where one country has a monopoly position in a technology.¹¹⁸ There is an issue concerning the possibility of global monopoly and a possibility for the state to grant subsidies and to enter the market and to have a change to capture some of the potential monopoly profits¹¹⁹.

However, the special nature of the hard-defence sector has to be kept in mind. The government has to think about both the economic and security sides of imports, production and exports of arms, when thinking and deciding on arms trade policy¹²⁰. When producing domestically, the state does not have to be afraid of possible future embargoes of spares or munitions by the countries, from which the arms are imported. But it may be that the domestic production is not affordable due to for example the very high fixed R&D costs of modern weapon systems, only the largest countries can afford to produce such arms.¹²¹

However, as it was said before, there may be uncertainty of supply of arms in a case of a conflict. That is why the states consider it important to have a domestic defence industrial base.¹²² “From the point of view of a national government, arms are imported chiefly because they cannot be produced domestically at an acceptable cost, and are exported because they are already produced for domestic use.”¹²³ So, sometimes subsidies, as well as other kind of state aid, are seen acceptable by the governments, although the return is negative.

The following quotation presents a couple examples of government policies and actions supporting domestic industry, which were not seen beneficial by every party:

“The selling government may buy unsuitable equipment for itself to promote export sales. This was the case with the 1995 UK choice of EH101 helicopters for army transport, which was driven by the need to maintain its export

¹¹⁸ Levine, Paul & Smith, Ron, *The arms trade – winners and losers* (1997) p. 346.

¹¹⁹ Levine, Paul & Smith, Ron, *The arms trade – winners and losers* (1997) p. 338.

¹²⁰ Levine, Paul & Smith, Ron, *The arms trade – winners and losers* (1997) p. 339.

¹²¹ Levine, Paul & Smith, Ron, *The arms trade – winners and losers* (1997) p. 338.

¹²² Levine, Paul & Smith, Ron, *The arms trade – winners and losers* (1997) p. 342.

¹²³ Levine, Paul & Smith, Ron, *The arms trade – winners and losers* (1997) p. 342.

prospects. Ministers had to order the Chief of Defence Procurement to override his duty to buy the US helicopter which represented best value for money. The French armed services have also regularly objected to having to accept equipment designed for export markets rather than their needs. The selling government also incurs substantial marketing costs.”¹²⁴

In addition, this preferential purchasing is at least to some extent objected by the industry associations as well as by some companies. In the following chapters I will go through more reasons against state aid as well as reasons, which support the state aid in this sector.

5.3. Arguments Against Restrictions of Competition and State Aid in Defence Sector

One of the companies requesting for changes in European defence market is the Europe’s leading aerospace and defence group French-German European Aeronautic Defence and Space Company (EADS). Last November chief executive of EADS, Philippe Camus, stated that the industry associations in both Europe and North America are encouraging their governments to “open up the playing field for co-operation and competition”. These associations have sent together a letter to the US Congress stating that they oppose the US “buy American products” policy. Mr Camus also stated: “This kind of protection is not supported by industry.” He also said that the creation of environment in which industrial partners can concentrate on delivering the most advanced systems in the way that is the most cost-efficient should be supported.¹²⁵ There are more comments as well against subsidies in the defence industry. According to Paul Ingram from Oxford Research Group:

“UK Government support for arms exports and the defence industry has been based for too long on an unchallenged belief that it is good for jobs, the economy and our military. Defence export jobs alone are each subsidised by

¹²⁴ Levine, Paul & Smith, Ron, *The arms trade – winners and losers* (1997) p. 346.

¹²⁵ Betts, Paul, *EADS technology conference: Europe ‘must speed plans for R&D defence body’* (2003) p. 3.

*£4,600. It is time for an open and public debate on the arms subsidy trap in which the Government finds itself.*¹²⁶

Moreover, Dr Ian Davis, Arms and Security Programme Manager, in Saferworld has stated:

*“At least £420 million of taxpayers' money goes directly into enabling foreign governments to purchase British arms. Ending the subsidy to the UK defence industry as a whole, which has no clear benefit to our armed services or national security, could save a further £4 billion. We question whether this is an effective and justified use of public resources.”*¹²⁷

They together studied about subsidies¹²⁸ granted to the defence industry in the United Kingdom and were not satisfied with the current situation of granting state aid to defence companies. Firstly, in the report they give four main types of government subsidy that are export credit guarantees, marketing and other support through government agencies, tax breaks on bribes and other corrupt practices, and distortion of Ministry of Defence purchasing and other priorities. They also mention an indirect way for subsidy, for example subsidy to arms exports through the aid granted by Government on research and development of new weapons that are planned to be exported. This, as well, is covered by tax money.¹²⁹

In the report, Ian Davis and Paul Ingram disagree with the claim that arms exports and supporting a UK defence industry are very important for jobs. On the other hand, they argue that it would be a long-term benefit of the British economy and employment, if the Government would invest the money currently invested in arms industry on creation of new jobs in other sectors of the economy. In the report, they estimated that the UK government spends £4,600 for every 90 000 job which depends on arms exports and that is 0.3 % of the employment in the UK. Moreover, it was stated that the governmental spending on subsidies on every job in the wider UK defence industry is £12,300 per year.

In addition, they claim that the subsidies granted to the UK defence industry sector leads to the purchasing policy of “buy British” within the Ministry of Defence and that distorts procurement decisions. They also claim that despite the subsidies, the domestic

¹²⁶ Anonymous, *UK Government Subsidies to the Arms Trade, Outline of ‘The Subsidy Trap’ report.*

¹²⁷ Anonymous. *UK Government Subsidies to the Arms Trade, Outline of ‘The Subsidy Trap’ report.*

¹²⁸ They wrote together a report ‘The Subsidy Trap’ in 2001.

¹²⁹ Anonymous. *UK Government Subsidies to the Arms Trade, Outline of ‘The Subsidy Trap’ report.*

equipment procured by the Ministry of Defence have been often faulty equipment. Thus, Saferworld and the Oxford Research Group recommend that the UK Government should:

- “ - Undertake a comprehensive review of arms subsidy policies.
- End Export Credit Guarantee Department (ECGD) support for arms exports.
- Close down the section in the MoD¹³⁰ that promotes UK arms exports, the Defence Export Services Organisation (DESO).
- Levy charges on government services to defence exporters so that government costs are fully recovered.
- Institute full parliamentary and public transparency of government support to the defence industry.
- End MoD payment for military research and development (R&D) costs.
- Move the Defence Diversification Agency (DDA) from the MoD to the DTI¹³¹ and mandate a review of economic and industrial policy.
- Commission an independent study of UK defence procurement options.”¹³²

However, Mr Camus, from EADS, has admitted that strong and active support by governments is still needed. He stated that even with alliances and partnerships, the amount of which he believes will grow, the companies cannot provide the level of industrial co-operation that is necessary, so that competition can be maintained and innovations are driven forward, unless the governments will support the industry.¹³³ So, in the next chapter I will go through reasons for state aid in the defence industry.

5.4. Arguments for Maintaining the State Support for Defence Sector

One of the arguments for maintaining the governmental subsidies granted to defence companies is the maintenance of defence equipment industry in the country so that there is some form of independence and security of supply during a possible conflict as well.¹³⁴

¹³⁰ I.e. Ministry of Defence (authors notice)

¹³¹ I.e. Department of Trade and Industry (authors notice)

¹³² Anonymous. *UK Government Subsidies to the Arms Trade, Outline of 'The Subsidy Trap' report.*

¹³³ Betts, Paul, *EADS technology conference: Europe 'must speed plans for R&D defence body'* (2003) p. 3.

¹³⁴ Hartley, Keith, *Defence Economics and the Industrial Base*, p. 6.

Another argument for the subsidies is a strategic trade policy. In a situation where there is rivalry between a small numbers of big companies the existing companies may try to create strategic entry barriers in order to maintain the market share of theirs. An example of such a market is the market for large civil aircraft. If there were no Airbus, Boeing, being strongest in the market, would have a monopolistic position. Thus, in order to have this competition it may be beneficial to have subsidies. The subsidies are also a signal to Boeing not to try a price war to force Airbus out of the market. So, these kind of strategically important industries may be characterised by imperfect competition. However, on this kind of markets the subsidies do not guarantee success on the market.¹³⁵

Thirdly, due to the nature of the industry, R&D is important and subsidies are needed so that companies are willing to invest in R&D as much as the society regards as desirable. In addition, external economic benefits are used as favourable arguments for subsidies, i.e. employment, technology, and balance of payments. Furthermore, it is also argued that other countries grant subsidies to their companies, so it is necessary to give state support for national industry as well in order to them to be competitive.¹³⁶

5.5. Summary Concerning State Support in Defence Sector in the EU

It has been argued that maybe the most important way in which states can distort trade is through state aid. It has been seen as a political decision. The governments try to enhance the competitiveness of domestic companies. In addition, according to Spencer-Brander theory when there is imperfect competition, the governments may be willing to intervene in order that a domestic company would get the excess profit possibly available in the market. The reason to intervene may be different in the defence sector due to its sensitive and special nature.

According to the theory, the subsidy may sometimes be beneficial and sometimes not. This has been argued to apply to the hard-defence sector as well by different parties. It has been argued that some state aid restricts competition but on the other hand it has been claimed that some state aid is still needed.

¹³⁵ Hartley, Keith, *Defence Economics and the Industrial Base*, p. 6.

¹³⁶ Hartley, Keith, *Defence Economics and the Industrial Base*, p. 6.

However, it is seen that the intervention is not so often beneficial. It has been seen as creating dependence on government support. Actually, it has been argued that it may be that the real economic return on arms exports could be negative. For example the amount of subsidies support this view. In addition, the states have become more lavish in granting subsidies in order to keep domestic companies in the market. Also, the profitability of the sector has decreased. This could be for example due to reduced demand and increased competition. Actually, the government of the exporting company may subsidise the purchaser through its aid. So, the national return could actually be negative.

However, the special nature of the industry has to be kept in mind. Due to the security of the nation and in order to ensure the supply of arms in conflict situation, the states may be willing to have negative return on subsidies.

However, is this the most efficient way to support the industry in the European Union? There are arguments against and for the state support. There are requirements to open this sector to competition and cooperation. In addition, some companies as well as industry associations have argued against the policy to buy domestic products. In addition, some have argued that the tax money is not invested and used well in this industry.

However, it has been admitted that the government support is needed now and in the future for example for R&D, so that the companies can do R&D as much as it is necessary. In addition, as it is stated before, the reason to support this industry is to maintain arms production within that particular state. However, it could be asked: is this current way the best possible way to support the competitiveness of the European hard-defence industry, as the current situation is that the European companies have problems to compete with the companies from the United States? The Commission of the European Union has noticed the difficult situation of the armaments industry as well as has tried to find a solution. The suggestions of the Commission as well as the opinion of European Economic and Social Committee regarding to the suggestions are briefly covered in the seventh chapter. The next chapter includes findings based on the study of this thesis.

6. Findings of the Study

The aim of this study is to answer the question presented at the beginning, which is:

What is the role of governments and governmental state aid, which is made possible by Article 296 EC, on hard-defence material sector in Europe?

In order to answer this I studied the industry and factors affecting competition within the industry as well as how Article 296 EC is applied in a situation of state aid. Also, the role of state aid was studied.

It was found out that the current situation of European hard-defence industry is not so good and the European companies have problems to compete with companies from the United States. As one reason, it has been stated that the U.S. companies can enjoy economies of scale due to the larger as well as quite well protected domestic market. On the other hand, it has been said that in Europe the armaments market has fragmented into many small markets and costly duplication still exists.¹³⁷

In the European Union, in which common policies and rules are created to ensure the fair trade and competition, the trade on hard-defence material and equipment is still covered by the legislation of the Member States. The impact of the governments of the Member States on trade of hard-defence material is still quite strong, as presented before, due to their strong involvement in the industry as regulators, purchasers and investors/supporters. Through these different roles the governments of the Member States affect the operation as well as competition and trade of the hard-defence material companies. This is possible due to the existence of Article 296 EC.

However, the hard-defence material industry has become more concentrated and companies have merged in order to remain competitive. Cross-border mergers have happened as well, for example EADS was established when French and German companies merged. In addition, the companies often have foreign trade as well and the national governments are not usually the sole customers. So, the companies are not staying within the borders of one nation.

¹³⁷ See for example Schmitt, Burkard, *The European Union and Armaments, Getting a Bigger Bang for the Euro* (2003) p. 12.

However, according to this study and analysis of the industry the governments of the Member States seem to play a strong role in the operations of the hard-defence sector. Actually, the Member States are still, although less, quite protective towards domestic armament industry and through different ways the Member States affect the industry and operations of the companies within the industry. Moreover, it has been seen that the impact of the government intervention and state aid can be beneficial but also not beneficial.

Article 296 EC makes it possible for the Member States to grant state aid to defence companies. This state aid may affect the competition within the common market in the European Union. This is acceptable in the European Union, if the target of the aid is mentioned in the list of the Council referred to in Article 296 EC and the measure is necessary to protect the security of the nation. However, the aid cannot adversely affect the competition in the common market on products, which are not intended specifically for military purposes. The application of this Article in situation of state aid was shown in this study by presenting the Decision of the European Commission as well as the case from the European Court of First Instance.

However, as it was found out, it has been argued that one of the most important ways that the states may distort trade is through state aid. State aid is seen to be sometimes beneficial but sometimes it has been argued to distort competition. In the arms sector it has been claimed that the real economic return on arms exports could be negative, and the amount of current subsidies is seen to support this view. The governments are actually claimed to support the buyer through state aid to defence companies. In addition, it has been claimed that state aid to defence sector does not give as high value to the spent tax money as it should.

The economic side is, however, only one side of the issue. The special and quite sensitive nature of the sector has to be remembered. The governments may be willing to have negative returns in order to maintain domestic defence industry.

There are arguments for and against the governmental state aid. Some companies, industry associations as well as some researchers criticise the current situation and require change. Especially there are arguments against policies to buy domestic products. They are seen to restrict competition. However, it is widely agreed that some state aid is always needed for example in order that the companies are able to do R&D as much as it is needed.

So, state aid is seen to adversely affect the hard-defence sector in Europe. However, it is also seen necessary on certain fields. In addition, due to the special nature of the sector, the governments seem to be willing to have negative return on aid.

Is this the best situation? Currently the European hard-defence companies have problems to compete with the companies from the United States. In the next chapter the suggested changes by the Commission of the European Union for the scope of Article 296 EC is presented together with the opinion of European Economic and Social Committee. Furthermore, at the end I have included a little my own discussion about the findings of this study and about the suggestions of the Commission.

7. Future Suggestions for the Hard-Defence Material Sector in the European Union

7.1. The European Commission

The harmonisation of the legislation related to defence procurement and industry is not advanced much yet. The Commission of the European Union has, however, recognised this and also the need for the harmonisation. As Erkki Liikanen, European Commissioner for Enterprise and Information Society, has said in his speech at the Forum Europe 5th European Defence Industries Conference in Brussels on 23rd May 2000 that the defence related issues are not moving so fast in developing the conditions which would make the industry to become more competitive and something should be done for this.¹³⁸

The Commission has in its Communication in 1997 suggested following changes for public procurement and for the scope of Article 296 EC (at that time Article 233 EC). The Commission suggested that there should be a concrete system of rules to be applied to procurement of defence equipment making competitive tendering possible whenever it is feasible. In order that the sensitivity and special needs for confidentiality and security of supplies are taken into consideration, there should be an appropriate level of flexibility. To make this possible the Commission suggested three categories, which are as follows¹³⁹:

- *Products intended for the armed forces but not for military use therefore not covered by Article 223 EC nor by Article 2 of the directive 93/36 (markets declared secret, protection of vital interests, national security, etc). As these products are already subject to the Community public procurement rules, the Commission will specify, where appropriate, in the most suitable form the conditions for the application of these rules;*
- *Products intended for the armed forces and for military use, but not constituting "highly sensitive defence equipments". The Commission could work out a fairly flexible set of rules, while respecting the principles of transparency*

¹³⁸ Liikanen, Erkki, *The role of the EU and European Commission initiatives to promote a competitive European defence technological and industrial base* –speech (2000).

¹³⁹ Communication of the Commission, COM (97) 583 final, *Implementing European Union Strategy on Defence-Related Industries*, 12.11.1997.

and non-discrimination, inspired by the existing Community public procurement rules;

- Highly sensitive equipments covered by the scope of Article 223 EC. These products could be exempted from the rules referred to above when safety or the protection of vital national interests of the country in question so require. A notification mechanism for this purpose should be foreseen in order to ensure a degree of control and transparency.¹⁴⁰

In the latest communication the Commission of the European Union has stated that it “continues its reflection the application of competition rules in the defence sector taking due account of the specificities of this field and the provisions of article 296 TEC.”¹⁴¹ In addition the Commission stated that it would initiate actions in order to optimise defence procurement in both national and the European Union level¹⁴². It states in the Communication also that the end goal is to have common procurement rules for the defence equipment in the European Union. The application of the common rules would depend on the sensitivity of the products as it is stated in the Communication. Also, the Commission states that after creating a European defence equipment market, which is based on fair competition, the offsets would not be required anymore.¹⁴³ So that when awarding a contract the winner should not involve in the production or otherwise enhance the industry of the purchasing state.

Furthermore, as stated before the Commission would be willing to increase the application of competition rules on defence sector. Actually, the Commission has introduced its own policy guidelines related to this. “As far as the financing of military R&D by Member States is required, the Commission takes account of the particularities of the defence related activities, namely a high technology base of production, high costs and a very long development cycle, which, to a large degree, require public financing.”¹⁴⁴ Thus, the need for some state aid is acknowledged in the European Union.

¹⁴⁰ Communication of the Commission, COM (97) 583 final, *Implementing European Union Strategy on Defence-Related Industries* (1997).

¹⁴¹ Communication of the Commission, COM (2003) 113 *European Defence – Industrial and Market Issues: Towards an EU Defence Equipment Policy* (2003) p. 19.

¹⁴² Communication of the Commission, COM (2003) 113 *European Defence – Industrial and Market Issues: Towards an EU Defence Equipment Policy* (2003) p. 19.

¹⁴³ Communication of the Commission, COM (2003) 113 *European Defence – Industrial and Market Issues: Towards an EU Defence Equipment Policy* (2003) p. 15.

¹⁴⁴ Trybus, Martin, *European Defence Procurement Law: International and National Procurement Systems as Models for a Liberalised Defence Procurement Market in Europe* (1999) p. 93. Mr. Trybus has quoted the Communication (COM (96) 10 final, p. 24).

Moreover, the Commission stated that the Court judgments have helped to define the scope of Article 296 EC and the Commission will issue an Interpretative Communication by the end of 2003 related to the implication of these judgements.¹⁴⁵

7.2. The European Economic and Social Committee

The European Economic and Social Committee supports some of the activities the Commission has stated in the latest Communication (COM (2003) 113). It deems that it is necessary to maintain a defence industrial base in the European Union, which is able to compete globally. If this does not exist, the Member States should rely on third countries, mainly to the United States, in order to have defence equipment. So, the Committee sees it important to have and develop an 'EU defence market'.¹⁴⁶

According to the Committee, the state involvement exists and cannot be avoided. This is, because they are normally the only customers. However, the Committee stated in its opinion that state's ownership should be limited as much as possible, so that the competition would be meaningful. However, state involvement, according to the Committee, will stay in the fields, which are very sensitive (e.g. nuclear and cryptographic). The Committee deems as well, that the State support for RTD (research, technology and development) is needed, so that the armed forces can stay on the top of the technological advancement.¹⁴⁷

According to the Committee, the needed restructuring will mean that the Member States will lose some domestic defence industrial capabilities while concentrating on others in this restructuring process, which has already started. The goal is to ensure that there is a full range of industrial capabilities needed by the EU defence in the European Union.¹⁴⁸

¹⁴⁵ Communication of the Commission, COM (2003) 113 *European Defence – Industrial and Market Issues: Towards an EU Defence Equipment Policy* (2003) p. 19.

¹⁴⁶ European Economic and Social Committee, *Opinion on the Communication of the Commission COM (2003) 113, European Defence - Industrial and Market Issues - Towards an EU Defence Equipment Policy* (2003) point. 3.1.

¹⁴⁷ European Economic and Social Committee, *Opinion on the Communication of the Commission COM (2003) 113, European Defence - Industrial and Market Issues - Towards an EU Defence Equipment Policy* (2003) point. 3.4.

¹⁴⁸ European Economic and Social Committee, *Opinion on the Communication of the Commission COM (2003) 113, European Defence - Industrial and Market Issues - Towards an EU Defence Equipment Policy* (2003) point. 3.6.

The opinion of the Committee on having common rules for defence procurement is quite positive and it sees that it should be the long-term aim. However, it states in its opinion that it will take a long time to achieve this due to the very different rules that the Member States currently have.¹⁴⁹

The position of the Committee towards the Commission's suggestions on competition policy is positive and the Committee totally supports the general position of the Commission. However, the Committee stated that while limiting the scope of Article 296 EC the possibility of the Member States to safeguard their national security interests should not be reduced. It also reminded that because of the strong interests and involvement of the states, it is harder to ensure competition on defence products than on other products.¹⁵⁰

¹⁴⁹ European Economic and Social Committee, *Opinion on the Communication of the Commission COM (2003) 113, European Defence - Industrial and Market Issues - Towards an EU Defence Equipment Policy* (2003) point. 4.3.

¹⁵⁰ European Economic and Social Committee, *Opinion on the Communication of the Commission COM (2003) 113, European Defence - Industrial and Market Issues - Towards an EU Defence Equipment Policy* (2003) point. 4.4.

8. Author's Discussion on the Study and an Overview

8.1. Author's Discussion

The current situation of defence industry in Europe is not so good. According to the knowledge I have got while studying the field, the governments of the Member States have a strong role how the industry is operating and doing. Before, when the states had higher defence budgets, they were better able to finance the operations of the domestic defence companies. Thus, it was possible that the companies were able to survive with serving the domestic needs. In addition, the political situation used to be different.

However, the situation has changed. The military equipment needed nowadays is more expensive to produce. In addition, the defence budgets of different countries have decreased. There has also happened a lot of integration in the European Union. Moreover, the companies are willing to look for economies of scale outside the domestic borders, and the states, as well, are nowadays more willing to import products. Thus, there is more cross-border trade of military products in the European Union.

However, it has been argued, that the markets in Europe are still quite fragmented and the companies are not doing so good and are not able to compete with the American companies. While studying this field I got a feeling that the governments are behind the current situation. They affect the trade and competition in the hard-defence sector through different ways, through restrictions of trade, as well as through supporting domestic companies.

Based on the information got from this study I would suggest that some changes should be made for the current situation. Because it has been seen that the existence of Article 296 EC is hindering the change, although there are political issues and differing views of the Member States behind it, I would suggest as the Commission has suggested that the scope of Article 296 EC would be narrowed. Of course, due to the sensitivity of this field, as the Economic and Social Committee stated, the possibility for the Member States to safeguard their national security interest should be maintained.

According to many studies, the armaments industry in Europe is not very competitive and the subsidies of the governments are seen not to create positive return, but they are sometimes seen as a misuse of tax money. However, as found in this study, some sort of state

aid is needed for example in order to for companies to be willing to invest as much as needed in research and development. However, I would suggest that it should be more closely controlled by the European Union so that it would not unnecessarily hinder or restrict the competition within armaments industry.

Justification for the state aid in the defence sector could be gained through exemption based on the support to research and technological development. Article 87 EC prohibits state aid, which distorts or could distort competition within common market. In Article 87 (3) EC there is, however, a possibility for an exemption if the aid enhances the attainment and realisations of an important project that is of common European interest. In addition, in the same Article there is a possibility for an exemption if the aid enhances a development of economic activities as long as the aid does not affect the trade to an extent that is incompatible with the common interest. And as stated before, the Commission has acknowledged the special nature of the sector and need for expensive and long development cycle, which require aid.

Thus, if the scope of Article 296 EC is narrowed, the state aid, when needed, could be possible, but that there would be less unnecessary support and restriction of trade, and the aid could be controlled more by the Commission. Thus, it could enhance the possibility for fair trade and competition on hard-defence sector within the European Union.

The need for change is acknowledged quite widely. However, due to the sensitive nature of the industry, there are obstacles that have to be dealt with before the changes can occur. There have been attempts to improve the situation of the defence sector outside the European Union as well as in the Union in Europe. The atmosphere for accepting the changes is probably getting better as the current situation has been acknowledged to be not so good as well as through increased cross-border operations. The future will show, what will happen to the hard-defence sector in the European Union and whether the Member States are able to overcome the current obstacles before increased cooperation and integration.

8.2. Overview of the Study

In this study the current situation of the hard-defence industry was introduced and the strong role of the governments. At the beginning I chose to limit the study on impact of the governments through state aid. In addition the perspective was chosen to cover suppliers and

purchasers. If I had concentrated only on either the supplier or the purchaser, I could have got a deeper view into the subject from the point of view of one participant.

In addition, the economic perspective is not the only relevant issue in order to explain the state aid in hard-defence sector, but there is security and political issues as well, which strongly impact the state aid regimes. Thus, if the political view was included in this study, the result would be more informative about the factors behind the state aid as well as behind the current situation of the hard-defence sector itself.

Furthermore, while I decided to concentrate on state aid, I left for example the analysis of the mergers and acquisitions out and the impact of Article 296 EC on them in the European Union. Currently, the mergers concerning only in the hard-defence sector do not fall within the regime of the EC legislation. From the point of view of mergers, the answer, whether the parties would like to narrow the scope of Article 296 EC, could be different.

This study covers only one of many issues affecting the hard-defence sector, the governmental state aid. Although there are many issues that are not covered in this thesis, I believe that the purpose of this thesis is reached and I hope and I believe that the readers get a good view of the current situation of the hard-defence material sector and of the role of the governments and governmental state aid in the sector.

9. Conclusion

The purpose of this study was to first analyse the industry and to find out what are the factors affecting the operations of the industry. It was found out that the governments of the Member States play very important roles. This is due to the close relationship between the industry and the governments due to the fact that the legislation concerning the sector is covered by the Member States and foremost, because the states are basically the only buyers of hard-defence products. The governments are involved in supporting the industry as well. Furthermore, it was found out that the industry in Europe is not doing so good. Among other things, the fragmentation and over-capacity of the market due to the preferences of the states was found to be reasons for this.

There is legislation in the European Union, which aim to ensure fair trade and competition within the common market. However, the trade on hard-defence material and equipment falls still under the governance of the legislation of the Member States due to the possibility to apply Article 296 EC. Due to this fact, the competition legislation of the European Union is not applied on hard-defence material sector, and thus, the Member States can have a strong role and impact on the industry, and also state aid is possible.

Different kinds of state aid were found to affect the competition and operations of the industry. It was found out as well that state aid might be beneficial as well as non-beneficial. It was interesting to find out that the states are willing to have a negative return on state aid in order to maintain and support domestic defence industry. Thus there are political as well as national security issues that affect the state aid regimes in the hard-defence sector.

The companies as well as the states have started to have more cross-border transactions. In addition, the need for change and improvement of the situation of the defence industry has been quite widely acknowledged. Furthermore, there have been attempts to have more cooperation as well as common policies in the armaments sector in as well as outside of the European Union, and some actions have been already taken. The Commission of the European Union for instance has been active in trying to get the hard-defence sector more under the governance of the European Union and thus it has for example suggested some changes to narrow the scope of Article 296 EC. Thus the change may be on its way, and the future will show what will happen to the armaments industry in Europe.

10. Appendix

Appendix 1: List of Council of products on which Article 296 EC is applied.

It reads as follows:

1. Small arms a) rifles, carbines, revolvers, pistols, sub-machine guns and machine guns excluding hunting rifles, small-calibre pistols and other small calibre guns with a calibre less than 7 mm, b) machine guns for field and anti-aircraft artillery as well as for the armament of vehicles, aircraft and vessels.
2. Heavy weapons such as a) cannons, b) howitzers, c) mortars, d) heavy guns.
3. Launchers of any kind of rockets.
4. Starting equipment for any kind of flying objects.
5. Built-in equipment, gun-mounts and related equipment, directional and stabilisation equipment as well as automatic loading equipment, fire direction equipment for the equipment stipulated under 1 - 3.
6. Built-in equipment, gun-mounts, and related equipment and steering equipment for the equipment stipulated under 4.
7. Munitions, rockets, and flying objects for the weapons stipulated under 1 – 4.
8. Bombs, torpedoes, hand-grenades, mines, and combat equipment for engineer troops including attached dropping, ejection and unveiling equipment.
9. Instruments and devices for military purposes, especially constructed for handling, the placement, searching, the arming and disarming equipment stipulated under 8.
10. Components of equipment stipulated under 1 - 6.
11. Components of equipment stipulated under No. 7 and 8 as a) explosives and inflammable devices, b) propellants and fuels (solid or liquid), c) pyrotechnical sets, d) inflammable fuses, etc.
12. Fire direction materials for military purposes, a) Flight path detection devices, infra-red target devices and other night targeting equipment, b) range finders, location finders, altitude finders, c) electronic, gyroscopic, optic and acoustic observation equipment d) adjustment devices for the dropping of bombs and altitude fixing devices for cannons, sighting equipment for the material stipulated on this list, e) fire direction calculators, data processing and periphery components for direction finding.
13. Armoured vehicles and vehicles especially constructed for military purposes a) tanks, b) military vehicles, armed or armoured, including amphibian vehicles, c) military

- vehicles (semi-tracked vehicles), d) armoured engineering machines, e) military vehicles for the maintenance/repair of armoured vehicles, f) trailers especially constructed for the transport of munitions stipulated under 7 and 8. g) Non-armoured vehicles (soft skin) constructed or developed for military purposes, especially equipped for military purposes.
14. Toxic or nuclear devices a) biological or chemical toxic substances and nuclear substances for the extinction of humans, animals or harvests in the case of war, b) military devices for the dissemination, detection and identification of substances stipulated under (a). c) Devices for the protection against substances stipulated under (a).
 15. Military vessels and their special equipment: a) warships of all kinds, including navy-peculiar support ships, b) special equipment for the placement of mines, detection of mines, deployment of mines and the searching of mines, c) sub-marine combat and defence devices, submarine nets, d) equipment for combat swimmers and mine divers, e) single devices and equipment as far as they have an impact on the military operation of the ship.
 16. Aircraft and their devices for military purposes.
 17. Electronic-optioned equipment for military purposes (see also No. 22).
 18. Take-in devices especially designed for military purposes (gun mounts).
 19. Miscellaneous equipment and devices: a) parachuted and parachute devices, b) devices to cross waters especially designed for military purposes, c) material for the exploration of waters and their sides, d) electronically regulated projectors for military purposes.
 20. Parts and single parts of devices stipulated on this list, as far as they are of a military character.
 21. Machines, devices and tools exclusively developed for the development, production and control of the weapons, munitions and purely military devices stipulated on this list.
 22. Military directing systems and their components, as for example special calculators, exhibition devices and peripheral devices.¹⁵¹

¹⁵¹ Taken from the book of Martin Trybus, *European Defence Procurement Law* (1999) p. 14. It is a translation of the German text by the Martin Trybus and Simon Nolan.

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¹⁵² ISS is an agency of the European Union and its core mission is to provide analyses and recommendations to assist the formulation of the European security and defence policy.

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