

PART III

LEGAL ASPECTS
OF INVESTMENT
AND FINANCING

LEGAL ASPECTS OF DEFENCE PROCUREMENT IN THE EUROPEAN UNION: FUNDING INCENTIVES AND REGULATORY SHIELDS



BÁLINT KOVÁCS

*‘Every gun that is made, every warship launched, every rocket fired signifies,
in the final sense, a theft from those who hunger and are not fed,
those who are cold and are not clothed.
This world in arms is not spending money alone.
It is spending the sweat of its laborers, the
genius of its scientists, the hopes of its children.’
Dwight D. Eisenhower*

Abstract

This chapter presents an analysis of regulations established at the European Union level, particularly aimed at improving common defence capabilities by encouraging industrial development. It critically examines the specific instruments utilised by States in the course of defence procurement. First, it focuses on the “Defence Package”, outlining the purpose and content of this regulatory attempt to harmonise Member States’ legislation on the procurement and transfer of defence-related products. It then analyses the potential reasons for its limited application. This is followed by an inquiry into the potential for funding schemes to act as incentives to boost cooperative defence spending and encourage Member States to engage in the harmonised development of the European defence industry. The analysis also briefly evaluates the situation of small and medium-sized enterprises, particularly those within the novel funding schemes. Finally,

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it addresses the specific instruments regularly used by States in defence procurement, with an emphasis on defence offsets as a means for defence industrial protectionism.

Keywords: defence package, procurement, transfers, funding, SMEs, offsets

1. Introductory remarks: policy abundance, implementation dearth

The defence capabilities of the European Union (EU) and its Member States have often been analysed through the prism of their partnership with or membership in the North Atlantic Treaty Organization (NATO). This approach has so often been criticised in the media, that citation is not even warranted: the EU is overly reliant on the United States as a guarantor of its security. Criticism regarding modest defence spending by European members of NATO has also been highlighted by the media in recent years. However, since the war returned to Europe, even the most dovish of EU Member States have augmented their defence spending, or have at least committed to doing so. The question now is, how best to spend this money? How best do you fulfil these commitments? The challenges are numerous, as industrial capacity has waned, not least because of the incongruence in spending priorities.¹ The ramp-up in spending comes at a time when the EU's pursuit of *strategic autonomy* also reappeared on the agenda with greater vigour. The concept of strategic autonomy re-entered public consciousness at a time when EU leaders were wary of NATO's direction.² This concept is now part of the EU's security and defence aims. The recent ramp-up in defence spending³ may well be attributed to crises at European borders, but increased spending must nevertheless be accompanied by increased cooperation.

Coordinating defence and security efforts has been on the EU agenda since its inception. The idea evolved over the decades,⁴ with common defence being developed as part of the Common Foreign and Security Policy (CFSP), and included in the Maastricht Treaty. This was then carried over through the Treaty of Lisbon into Chapter 2, Section 2 of the Treaty on European Union (TEU). A principal component of CFSP is Common Security and Defence Policy (CSDP), also known as the European Defence Union (EDU). The CSDP represents a platform through which EU Member States can combine resources to implement joint initiatives. Since its inception, numerous initiatives have been undertaken to give content to this cooperation. This includes the

1 As also acknowledged in European Commission, 2022, p. 1.

2 French President Emmanuel Macron expressed concerns that '[w]hat we are currently experiencing is the brain death of NATO'. As quoted in The Economist, 2019.

3 NATO, 2023.

4 Through initiatives such as the Western European Union's Petersberg tasks (Petersberg Declaration) or the Berlin Plus agreement.

European Security Strategy (ESS), which was first developed in 2003. However, despite its holistic approach to the questions of security and defence, it has overlooked an extremely important aspect of this cooperation: coordination in terms of defence procurement. The ESS was replaced by the EU Global Strategy in 2016, through which the importance of “concerted and cooperative effort” in defence spending became a major theme in CSDP.

Coordinated defence spending promises to enhance output and industrial growth. Therefore, it becomes a necessary tool for achieving strategic autonomy.⁵ Further policies and platforms have appeared to buttress such cooperation. The Treaty of Lisbon established the European External Action Service, a common structure created to carry out CSDP, among others. The Treaty also includes a mutual defence clause and introduces Permanent Structured Cooperation (PESCO) for Member States wishing to pursue defence integration. PESCO was first initiated in 2017 with the aim of increasing defence cooperation at a new level. Enhanced cooperation through PESCO, together with the Coordinated Annual Review on Defence (CARD), European Defence Fund (EDF), and Military Planning and Conduct Capability, are the main components of EU defence cooperation. Their activity is underpinned and coordinated by the European Defence Agency (EDA), which has been in existence since 2004, as well as the Directorate-General for Defence Industry and Space.

The aforementioned details are meant only as a brief stocktaking and are not aimed at providing a complete inventory;⁶ however, they illustrate that defence-related policies at the EU-level seem to be as fragmented as the EU defence market. This convoluted web of platforms and policies was intended to enable deeper cooperation among Member States under the brokerage of the EU. Furthermore, it is possible that without this convoluted web of platforms for coordinating political will, implementation of *jus cogens* defence-related instruments such as the “Defence Package”, would face severe shortfalls. These endeavours point to a European Commission that is expanding its role in the area of defence, both to bolster the capabilities of Member States, to secure the EU itself and to boost the European defence industry to generate growth.⁷

The number of documents addressing collective security matters has also increased. However, to what end? Recognising the importance of the industry in achieving common defence goals, the EDA advanced the Strategy for the European Defence Technological and Industrial Base (EDTIB) in 2007. Member States adopted the EDTIB Strategy, which aimed to integrate national defence technological and industrial bases to achieve self-sufficiency for security of supply at the EU level.⁸ Six years after the EDTIB Strategy was agreed upon, a study by the European Commission’s Directorate-General for External Policies of the Union analysed its progress.

⁵ European External Action Service, 2016, pp. 20, 45.

⁶ For a review of key defence policy instruments, see: Csiki Varga, 2024, starting at p. 207.

⁷ Britz, 2023, p. 217.

⁸ Directorate-General for External Policies of the Union, 2013, p. 8.

The analysis examined the trends dominating the European defence industry, and provided a grim outlook regarding the implementation of the strategy. The study called for a revision of EDTIB, as well as new policies to protect “key industrial capacities”, changes to funding and investment methods, and the use of structural and cohesion funds in relation to EDTIB. It highlighted the importance of harmonising demand, synchronising procurement and engaging in joint research and technology projects to develop EDTIB.⁹ When the study was released, European economic policy was dominated by austerity, aimed at countering and addressing the prolonged effects of the Great Recession and European debt crisis. The dire economic situation only accelerated the trend of decreasing national defence spending of Member States.¹⁰ The European Commission’s analysis openly stated that implementing the EDTIB Strategy was “increasingly unlikely”.¹¹ Over ten years have passed since the analysis was published, and effective cooperation between Member States seems to be stranded among the myriad plans and political declarations of intent.

It took an acute crisis to reignite discussions and willingness to engage in planning for common defence priorities at the EU level. Europeans are now more concerned about their safety than they have been for a long time, which leaves little opposition to increased defence spending and deepening of EU-wide defence cooperation. A recent poll by Eurobarometer, the official polling instrument of the European Parliament, shows that over three-quarters of Europeans favour common defence and security policies. Deepening cooperation within the EU on defence matters received overwhelming support (80%), while two-thirds said more funds should be earmarked for defence.¹² It seems that it is the appropriate time to make progress and deepen EU-wide cooperation in defence. This is particularly true in terms of increasing defence budgets and improving spending coordination. As this chapter demonstrates, leaders of EU Member States have only profited from the present opportunity to a limited extent. Political statements continue to outshine action, although there is a sense of urgency that has ignited recent actions.

The defence spending of individual EU Member States has increased significantly in the past couple of years compared to the period before Russia’s invasion of Ukraine in 2022.¹³ This is significant, as governments’ buying power is an important determinant of the ownership, size, structure and performance of national defence industries. While it is important that Member States improve their military capabilities, coordinated spending would be more beneficial to this end. Although Member States have repeatedly acknowledged this, increased spending at the EU level has seemingly pitted them against each other in a sort of *friendly arms race*. This once again brought to the fore previously-identified challenges. These are general challenges related to

⁹ Ibid., p. 11.

¹⁰ Ibid., pp. 13–14.

¹¹ Ibid., p. 10.

¹² *Standard Eurobarometer 99 – Spring 2023*, 2023.

¹³ NATO, 2023.

the EU budget, such as calculating cost-benefit aspects or overcoming the *juste retour* dilemma, as well as substantial legal limitations. In addition, specific issues relate to the defence industry itself, or rather with its protection at the national level, as well as the lack of coordination between national authorities. Deficiencies in cooperation appear as manifestations of a deeper issue, considering that steps have been taken to harmonise procurement rules along the lines of market logic.

This chapter focuses on analysing regulations established at the EU level, specifically aimed at improving common defence capabilities by encouraging industrial development. It critically examines the specific instruments utilised by States during the course of defence procurement. First, it focuses on the “Defence Package”, elucidating the purpose and content of this regulatory attempt at harmonising Member States’ legislation on procurement and transfer of defence-related products. It then analyses the potential reasons for its limited application. This is followed by an inquiry into the potential for funding schemes to act as incentives for boosting co-operative defence spending and encouraging Member States to engage in the harmonised development of the European defence industry. This analysis separately, albeit briefly, evaluates the situation of small and medium-sized enterprises (SMEs), and focuses on these companies within the novel funding schemes. The chapter also provides an overview of specific instruments used regularly by States in the course of their defence procurement endeavours, focusing in particular on defence offsets. The chapter ends with concluding remarks by the author.

2. The “Defence Package”: the glass half empty

Identifying the precise line in the division of competences within the EU may sometimes prove to be challenging. Although the division of competences seems obvious at first glance, when one examines the details of a particular area that appears to constitute the sole competence of Member States, one may nevertheless run into regulation from the EU. This is how the field of defence and security appears. Without delving into all the political iterations of EU institutions, especially the European Commission, in terms of improving the functioning of the internal market, two directives must be highlighted. Directive 2009/81/EC¹⁴ provides procurement rules specifically aimed at defence and security markets, while Directive 2009/43/EC¹⁵ contains rules on the intra-EU transfer of defence-related products.

14 Directive 2009/81/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of procedures for the award of certain works contracts, supply contracts and service contracts by contracting authorities or entities in the fields of defence and security, and amending Directives 2004/17/EC and 2004/18/EC, 2009.

15 Directive 2009/43/EC of the European Parliament and of the Council of 6 May 2009 simplifying terms and conditions of transfers of defence-related products within the Community, 2009.

The Defence Package, as the two Directives were collectively called, is described in the subsections below, highlighting its most important features. The aim of the Defence Package was to create a European Defence Equipment Market (EDEM) along the lines of market logic in congruence with fundamental freedoms. Although it appears suitable for this purpose, the results achieved thus far demonstrate that there is nevertheless room for improvement.

2.1. Procurement rules

It is not an understatement that procurement in the defence and security sectors has traditionally been opaque. The Treaty on the Functioning of the European Union (TFEU) includes an exception clause in Article 346¹⁶ that Member States may use to maintain the confidentiality of defence procurement, among others. As demonstrated herein, this exception clause is front-and-centre when it comes to old, ingrained habits of secrecy and protectionism in defence procurement being perpetuated. These habits are nevertheless present, despite efforts at the EU level aimed at improving European companies' access to Member States' defence markets by promoting fair and transparent practices in the procurement of defence-related products. EU Member States continue to use Article 346 apparently without restrictions to exercise economic protection and avoid the application of EU procurement rules in the defence sector.

The European Commission devised a plan to establish EDEM, aiming to strengthen EDTIB and develop its military capabilities. Accordingly, the European Commission considered it essential that the rules for procurement in the defence and security markets be harmonised. It advanced a proposal for a directive that was to become Directive 2009/81/EC (hereinafter the "Defence Procurement Directive" or "DPD"), aiming to enhance competition and transparency in this field, while limiting the use of Article 346 TFEU (or Article 296 at the time the Directive was drafted).¹⁷

DPD seeks to open up Member States' defence markets in front of defence companies based in other Member States. The scope of DPD was established in Article 2, and it is clear that the Commission was not reticent, ensuring that it includes as wide a range of contracts as possible in the areas of defence and security. Therefore,

¹⁶ Article 346 TFEU reads as follows:

1. The provisions of the Treaties 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 internal 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.

¹⁷ Recital 2, 4 and 20 of the Defence Procurement Directive.

DPD applies to contracts in the following areas: (a) the supply of military equipment, including any parts, components and/or subassemblies thereof; (b) the supply of sensitive equipment, including any parts, components and/or subassemblies thereof; (c) works, supplies and services directly related to the equipment referred to in points (a) and (b) for any and all elements of its life cycle; and (d) works and services specifically for military purposes or sensitive works and services.¹⁸ In terms of the value of the contracts, Article 8 establishes the thresholds for the application of DPD as follows: (a) 421,000 euros for supply and service contracts and (b) 5,150,000 euros for works contracts (excluding VAT in both cases). Considering the numbers involved in defence procurements, these thresholds appear to bring the vast majority of Member States' defence procurements under the purview of DPD. Chapter II, Section 3 of the DPD contains provisions on excluded contracts. Such exemptions include certain government-to-government contracts, as per Article 13(f) of the DPD; or co-operative research and development programmes, as per Article 13(c) of the DPD; or contracts awarded pursuant to rules contained in other international agreements (such as NATO). Another category of exemptions includes contracts governed by the rules of an international agreement between Member States and third countries, and contracts governed by the rules of an international organisation purchasing for its purpose, as per Articles 12(a) and (c) of the DPD. Such agreements and organisations may include the Organisation for Joint Armament Co-operation, the Letter of Intent Framework Agreement (LoI), or NATO's Support and Procurement Agency (NSPA).¹⁹ These rules appear to allow Member States room for manoeuvre, considering the complexity and sensitive nature of defence procurements. An exemption that is worth noting is made in the case of a 'contract for which the application of the rules of this Directive would oblige a Member State to supply information, the disclosure of which it considers contrary to the essential interests of its security.'²⁰ Similar to Article 346 TFEU exception, this exemption also allows for the invocation of essential security interests, which may also be prone to abuse. However, the issues surrounding the application of DPD are far greater than this exemption.

Chapter V of DPD contains rules pertaining to the procedures for awarding contracts. Contracting authorities must publish contract notices in the Tenders Electronic Daily (TED) database. Except for somewhat narrowly-defined exclusions, contracting authorities must award procurement contracts in accordance with one of the procedures laid down in Article 25 of the DPD. Contract awards within the scope of the application of DPD must adhere to the principles of equal treatment and transparency to ensure fair competition. It also lays down extensive rules for cases

18 Recital 10 and 11 of the Defence Procurement Directive contain further indications as to the interpretation of its scope.

19 A more extensive view on these exemptions is contained in: Friton, Wolters and Andree, 2020, pp. 28–39.

20 Article 13(a) of the Defence Procurement Directive.

in which contracting authorities may wish to include in their tender ‘particulars’ in order to safeguard security of information and security of supply.²¹

DPD was published in the Official Journal of the European Union (OJEU) on 21 August 2009 with a deadline of two years for its transposition by Member States. As shown by a Commission report published in October 2012, all but three Member States missed this deadline, prompting the Commission to bring infringement proceedings against them.²² Complete transposition of DPD was only accomplished by May 2013.²³ A research paper analysed contract notices and awards that appeared in the TED, starting from the entry into force of DPD in August 2011 and the end of 2014. According to this paper, in the first few years of the Directive’s implementation it was mostly used for ‘contracts dealing with services, acquisition of equipment deemed to be of a low strategic value and sub-systems’.²⁴ At that time, only a handful of Member States were responsible for the vast majority of TED publications pursuant to DPD. The empirical research presented in the paper shows that major contracts that had a structural effect on EDTIB were made outside the Directive. This means that the DPD did not manage to curb the use of Article 346 TFEU exception, and had limited overall effect on the *culture of secrecy* that characterises military procurement.²⁵ This can be attributed due in part to the incomplete transposition of DPD, as well as its novelty. In this regard, however, the cited paper’s authors expressed their concerns that even those Member States that did implement the Directive may feel discouraged and may thus be driven to change their attitudes and turn in the direction taken by the larger majority that did not apply it.²⁶ While the paper recognised that it was too early at the time of their analysis for significant conclusions to be drawn, it held that the DPD marked an important step in the procurement policy related to a sector as opaque as defence.²⁷ Almost a decade later, it is clear that despite their hopes, the same conclusions may still be drawn.

The European Commission conducted its own evaluation of the implementation of DPD, tapping into a wider range of sources such as consultations with the public, stakeholders and Member States.²⁸ In its report, the European Commission struck an optimistic note, stating that contracts awarded on the basis of the Directive amounted to over 30 billion euros in 2011–2015. However, the report also acknowledges that the total defence procurement expenditure of EU Member States and European Economic Area countries in the same period was approximately 81 billion euros per

21 Articles 22 and 23 of the Defence Procurement Directive.

22 European Commission, 2012.

23 European Commission, 2016b, p. 3.

24 Masson and Martin, 2015, pp. 5, 38.

25 Ibid., p. 38.

26 Ibid., p. 38. In a similar note, see: *Motion for a European Parliament Resolution on the implementation of Directive 2009/81/EC*, concerning procurement in the fields of defence and security, and of Directive 2009/43/EC, concerning the transfer of defence-related products, 2019/2204(INI), para. 11.

27 Masson and Martin, 2015, p. 36.

28 European Commission, 2016b, p. 2.

year.²⁹ According to the European Commission, the main explanation for this was the unevenness of the DPD's application across Member States, as demonstrated by the fact that only a handful of them were responsible for the vast majority of award notices.³⁰

The European Commission's report also analysed numbers regarding cross-border procurement, which demonstrated that 'around 10% of the value of contracts awarded under the Defence Procurement Directive has been won directly by foreign companies'.³¹ The efforts undertaken to stimulate competition via the DPD and, in this manner, to bring more opportunities to SMEs was not effective in this initial phase, the European Commission concluded.³² In terms of DPD's efficiency, consultations conducted by the European Commission revealed that stakeholders considered the costs to outweigh benefits. Nevertheless, the European Commission concluded that the DPD is "broadly efficient" in terms of cost and savings estimations.³³ This conclusion is a *glass half full* reading of the Directive's efficiency when constructive criticism would surely be in order.

Nonetheless, the limited success demonstrated by the implementation of DPD was recognised by the European Commission at the time of drafting the report. The report attributed it to the novelty of the rules and their uneven and partial use, as previously stated.³⁴ This being the case, the European Commission concluded that, 'overall the text of the Directive is fit for purpose, that the Directive is broadly on track towards meeting its objectives and that an amendment of the Directive is not necessary'.³⁵ In this sense, the issue is not the regulatory effort in itself; the DPD is fit for purpose, both textually and legally. The main impediment continues to be identified as being the conduct of Member States' authorities. Despite willingness from Member States to operate defence procurements in the EU internal market dimension, it is clear that they were actually unwilling to abandon protectionist practices.

Both the cited paper and the European Commission's report, which were drawn upon, underline that one of the main impediments to fully applying DPD is the continued use of Article 346 TFEU³⁶ and the broad interpretation of other exemptions mentioned herein.³⁷ A list, that is referred to in Article 346(2), contains the items to which the exception clause applies.³⁸ Scholars have noted that this list constitutes the source of further complications, not least because it was actually never published

29 Ibid., pp. 2–3.

30 Ibid., pp. 3–4.

31 Ibid., p. 5.

32 Ibid., pp. 7–8.

33 Ibid., pp. 8–9.

34 Ibid., pp. 5–6, 10.

35 Ibid., p. 10.

36 Masson and Martin, 2015, p. 38.

37 European Commission, 2016b, p. 6.

38 See: Extract of the Council Decision 255/58 of 15 April 1958.

in the OJEU, and its various versions circulating in the public domain also contain some differences.³⁹ The Court of Justice of the European Union (CJEU) has extensive jurisprudence regarding the use of Article 346 TFEU exception. The CJEU has repeatedly reiterated that security exclusions are exhaustive and must be interpreted narrowly.⁴⁰ Jurisprudence also underlines that this exception does not apply to dual-use products.⁴¹ However, this does not preclude their use, nor does it change exclusionary practices.

It is also worth noting that the European Commission published an interpretative communication on the application of Article 346 (then Article 296) exception back in 2006.⁴² This was prior to DPD, or the Treaty of Lisbon. Therefore, it may be concluded that Member States chose to maintain these “loopholes”, and consequently the possibility of exercising protectionism in defence procurement. There is also an inherent disadvantage in attempting to police the practice of utilising exclusions from DPD. The mentioned interpretative communication underlines that Member States are obliged to ‘provide, at the Commission’s request, the necessary information and prove that exemption is necessary for the protection of their essential security interests.’⁴³ This simple observation bears various consequences: Member States may continue using the exemption under Article 346, bearing the risks of what a potential *ex post* investigation may determine. These *ex post* investigations may have even more *potential*, depending on the disposition of the European Commission to initiate them. It is likely that, in a crisis situation such as the current one, the European Commission may feel inclined to turn a blind eye to the extensive use of the exception.

The challenges previously mentioned have endured over time, as demonstrated by a third evaluation and report on the implementation of the DPD elaborated upon the request of the European Parliament, which entrusted a rapporteur with this task in November 2019.⁴⁴ The report states that:

several Member States introduced in their legislation a specific procedure applying to contracts covered by article 346(1)(b) TFEU, still making it difficult to assess whether the article 346 exception has been used for justified reasons of protection of national essential security interests, or just as a way to limit the application of Directive 2009/81/EC.⁴⁵

The report noted that cross-border penetration and SME participation in defence contracts is insufficient, as is the level of cooperation within the EU regarding

39 Trybus, 2014, pp. 91–92.

40 These are analysed *in extenso* in Trybus, 2014, pp. 94–127.

41 Trybus, 2014, pp. 94–95, citing Case T-26/01, *Fiocchi Munizioni SpA v. Commission of the European Communities*, at para. 61.

42 See: European Commission, 2006.

43 *Ibid.*, p. 8.

44 Schwab, 2021, p. 4/25.

45 *Ibid.*

defence capabilities. Despite the continued challenges, the report also shares positive developments in terms of an increase in the number of contract notices and contract award notices in TED, as well as a rise in the proportion of procurements tendered through it.⁴⁶ Progress has been sluggish, but not inexistent. The application of the Directive has been under constant observation, and novel funding schemes aim to further accelerate and boost the development of EDEM.

An additional field identified as crucial in boosting EDEM, and included as such in the “Defence Package” is the harmonisation of transfer rules via the Transfers Directive.⁴⁷

2.2. Transfer rules

The Transfers Directive was created to improve EDEM by streamlining the rules and procedures regarding the cross-border transfer of defence-related products. These products are defined in the Annex of the Transfers Directive, which is regularly updated (the last update was in 2019).⁴⁸ To achieve this, the Directive introduced new licencing tools that are ultimately meant to simplify the cross-border transfer of defence-related products. The sensitive nature of these products requires licences for cross-border transfers, even within a single market. Divergent national rules on exporting defence-related products have been identified as essential factors constituting one of the major barriers to increased Europe-wide competition in this area. New tools have been developed with the expectation that they would bolster the integration of supply chains and enhance security of supply.⁴⁹

The common licencing rules proposed by the Transfers Directive are therefore meant to tear down barriers, unify the regime of risk control and extend the benefits of the internal market to defence-related products. The Transfers Directive establishes rules on the movement of defence equipment that extend to EU Member States as well as Norway and Iceland. The new tools include general and global licencing for the transfer of defence-related products in addition to the much-utilised individual licences. The Directive also introduced rules regarding the granting of licence exemptions, which were in turn meant to be determined by national governments.⁵⁰

Individual transfer licences allow an individual supplier to transfer a specified quantity of specific products to a single recipient in one or several shipments.⁵¹ Any

46 Ibid., pp. 4/25, 5/25.

47 Directive 2009/43/EC of the European Parliament and of the Council of 6 May 2009 simplifying terms and conditions of transfers of defence-related products within the Community, 2009.

48 The list of defence-related products was last updated via Commission Delegated Directive (EU) 2023/277 of 5 October 2022 amending Directive 2009/43/EC of the European Parliament and of the Council as regards the updating of the list of defence-related products in line with the updated Common Military List of the European Union of 21 February 2022, 2023.

49 European Parliament, 2021, para. B.

50 Article 4(2) of the Transfers Directive.

51 Article 7 of the Transfers Directive.

further attempt to make any other transfer obliges the supplier to request a new licence. The new licencing tools introduced by the Transfers Directive simplify the procedure by enabling licences to be extended to additional transfers. The so-called global transfer licences allow an individual supplier to make multiple transfers of specified products to specific recipients in one or more Member States for a period of three years, which may be renewed.⁵² General transfer licences cover certain types of defence-related products, making it possible for suppliers to effectuate transfers without requiring a specific licence. Such licences may also contain specifics regarding the countries to which they are extended, details of the purpose of the transfers and information on recipients of the products.⁵³

The general transfer licence constitutes the principal tool of the Transfers Directive, and its use and promotion by Member States were made mandatory. The Directive prescribes that, under certain conditions, Member States must publish general transfer licences covering situations such as when the transfer is made for the purpose of demonstration, evaluation, exhibition, or even maintenance and repair.⁵⁴ With this, Member States are basically encouraged to utilise the general transfer licence as a tool. However, Member States are at liberty to determine the types of products to which they want to extend such licences and the conditions applicable to them. In all cases, the national authorities must be notified of the first use of a general transfer licence. Recipients must obtain a certification to prove reliability and avoid misuse of licences.⁵⁵ Licences are uploaded to the Register of Certified Defence-Related Enterprises (CERTIDER), which also includes information on national contact points and general transfer licences. A quick browsing of the register reveals deficiencies in the implementation of the Transfers Directive, as demonstrated by the infrequent and scarce use of its tools.⁵⁶

An evaluation ordered by the European Commission in 2016 revealed that there were differences in the transposition of the Transfers Directive at the level of Member States, which constituted barriers to its application. This issue is similar to the Defence DPD. At the time the evaluation was undertaken, the individual transfer licences were still favoured over general ones, despite the express purpose of the Directive to streamline transfers by replacing the former with the latter.⁵⁷ Similar to the case of DPD, the European Commission concluded that the Transfers Directive did not require amendments but rather needed clarification.⁵⁸ For this reason, the

⁵² Article 6 of the *Transfers Directive*.

⁵³ Article 5 of the *Transfers Directive*.

⁵⁴ Specific obligations are included in Article 5(2) of the *Transfers Directive*.

⁵⁵ Article 9 of the *Transfers Directive*.

⁵⁶ *The Register of the Certified Defence-related Enterprises*. [Online]. Available at: <https://webgate.ec.europa.eu/certider/> (Accessed: 9 January 2024).

⁵⁷ European Commission, 2016b, pp. 5–6.

⁵⁸ *Ibid.*, pp. 10–11.

European Commission subsequently published recommendations in 2016⁵⁹ and 2018⁶⁰ aiming to assist Member States in harmonising the transposition and implementation of the Directive. Unfortunately, a sneak peek of the CERTIDER suggests that these efforts have not been met with an active response from Member States.

2.3. The “Defence Package” on balance

The “Defence Package”, which is aimed at boosting the internal market for defence-related products, seems to have been overridden by the internal market itself. Alternatively, they may be dominated by national interests. The need for ‘a common European security and defence culture’⁶¹ remains, and the challenges for its accomplishment appear to remain unsolved. The failings of the “Defence Package” have not been overturned, despite the apparent political agreement behind this task. The actions of Member States and industry actors seem to override the declared intent. The “Defence Package” had a difficult task from the outset. Starting with the Great Recession, there was a steady decrease in defence investment, which purportedly contributed to the renationalisation of supply chains, admittedly thwarting the objective of the “Defence Package” which was the ‘de-fragmentation of markets’.⁶²

The 2016 Evaluation of the Transfers Directive noted that this instrument has succeeded in creating a smaller European market for less sensitive equipment, but high-tech goods remained excluded.⁶³ Similarly, the 2016 report on DPD found that its objectives were only partially achieved.⁶⁴ While the presented challenges as to their implementation remain, the resolution of the European Parliament, drawing on the extensive analysis carried out on the “Defence Package”, does not recommend

59 Commission Recommendation (EU) 2016/2123 of 30 November 2016 on the harmonisation of the scope of and conditions for general transfer licences for armed forces and contracting authorities as referred to in point (a) of Article 5(2) of Directive 2009/43/EC of the European Parliament and of the Council, 2016; Commission Recommendation (EU) 2016/2124 of 30 November 2016 on the harmonisation of the scope of and conditions for general transfer licences for certified recipients as referred to in Article 9 of Directive 2009/43/EC of the European Parliament and of the Council, 2016.

60 Commission Recommendation (EU) 2018/2050 of 19 December 2018 on aligning the scope of and conditions for general transfer licences for the purposes of demonstration and evaluation as referred to in point (c) of Article 5(2) of Directive 2009/43/EC of the European Parliament and of the Council, 2018; Commission Recommendation (EU) 2018/2051 of 19 December 2018 on aligning the scope of and conditions for general transfer licences for the purposes of repair and maintenance as referred to in point (d) of Article 5(2) of Directive 2009/43/EC of the European Parliament and of the Council, 2018; Commission Recommendation (EU) 2018/2052 of 19 December 2018 on aligning the scope of and conditions for general transfer licences for the purpose of exhibition as referred to in point (c) of Article 5(2) of Directive 2009/43/EC of the European Parliament and of the Council, 2018.

61 European Parliament, 2021, paras. C, D.

62 European Commission, 2016b, pp. 7–8.

63 Ibid., p. 8.

64 Cf. European Commission, 2016b, p. 5.

revision, but rather improved implementation.⁶⁵ Research in this area has revealed that DPD has improved some of the protectionist procurement practices. The modest results show a reduction in the rate of single bidding and contracts awarded without calling tenders. However, there has been a simultaneous increase in the number of contracts awarded through non-open procedures.⁶⁶

The “Defence Package” constitutes a two-piece part of the many that complete the puzzle of the European defence equipment market. The large number of bureaucratic components in this area make it challenging to navigate without overlapping or inconsistent regulations.⁶⁷ The “Defence Package” itself very likely obfuscates the original intent of building EDEM, by containing the very means that make it possible to bypass participation in it. This is partly the reason why ‘a very high volume of procurement expenditure is still incurred outside the [Defence Procurement Directive] and that an overwhelming percentage of contracts are still awarded nationally.’⁶⁸ Member States continue to protect their domestic industries and use defence procurement to continue building them. While it may serve their national economies, it creates inefficiencies in common European defence endeavours. The choice of participating in the envisaged EDEM is considered challenging for smaller Member States with less-developed industries. Without exercising protectionism as part of their acquisition strategies, it is even more unlikely that they would ever be able to develop a domestic industry capable of feeding into the supply chains of dominant companies in wealthier Member States.

The lip service paid at the EU level for the purpose of DPD to improve competition seems understandable in this economic perspective. Less developed States with smaller industry actors run the risk of their defence industries being devoured as soon as the avenues for exercising protectionism are closed. This is also demonstrated by the fact that the East–West imbalance in the defence industrial landscape has only increased with the expansion of the EU.⁶⁹ The Member States’ approach, which in the defence procurement area was described as “domestic first”, may imply that the consolidation of the European defence industry ‘will more likely be industry-driven than policy-driven’.⁷⁰ Consolidation (also referred to in this context as “de-fragmentation”) appears as rather anti-competitive, but its necessity appears logical when the aim is to cover gaps and avoid duplication in defence-related products. The fragmentation in the European defence equipment market stems not from the emancipation of competition but, rather from the tenacious grip of persisting protectionism.

Beyond pure protectionism, the deficient implementation of the Transfers Directive, despite having been transposed by all Member States for well over a decade,

65 European Parliament, 2021, paras. D, 10–11, 14.

66 Czibik et al., 2020, p. 8.

67 European Commission, 2016b, p. 9.

68 European Parliament, 2021, para. 4.

69 Briani et al., 2013, p. 34.

70 Ibid., p. 59.

also points to a lack of trust between them.⁷¹ Wider collaboration within the EU seems more difficult to achieve, even when collaboration between three Member States is delayed by disputes over who gets to do what part.⁷² This would likely mean that any incentive programme at the EU-level requiring industry consolidation (i.e. smaller industry players being left by their home states at the mercy of the market) in return for promises of a type of dispersion of production would likely be viewed with suspicion. In addition, in the broader NATO context, EU industrial actors are also required to compete with U.S. exports. A previous round of relaxing of export control measures in the United States has been decried as handing these companies a regulatory advantage, and putting them on an “unequal footing” with European companies.⁷³ The significant political support in the United States for defence industrial policy is closely tied to the dispersion of production and politicians’ eagerness to create and maintain jobs. Emulating this at the European level would require concrete interventions or disproportionate incentives, which may clash with other interests and other EU rules.

With defence spending in decline at the beginning of the previous decade, some argued that the “Defence Package”, as a demand-based policy instrument, could not be expected to have effectively reorganised the structure of EDTIB.⁷⁴ Now that a crisis has ensued, and defence spending has been ramped up, it remains to be seen whether the demand-side approach of the “Defence Package” will be able to serve its purpose. To date, there has been much scrambling by Member States, once again in an individual manner, to stock weapons from wherever they can get them. In this sense, the news appears to be split almost evenly between announcements of plans for common acquisitions and new equipment acquisitions, following *everyone for themselves* shopping spree.

3. Funding defence cooperation to overcome reluctance

The choice of directives for 2009 was carefully considered. This legal instrument allows for flexibility by granting Member States some leeway during their transposition to adapt them to national priorities. However, more than a decade after the implementation of the “Defence Package” the envisaged results have only partially been achieved. EDEM continues to be fragmented, and the challenges that were supposed to be tackled still require resolution. The directives were used only in a limited manner, thus having a limited effect on the development of EDTIB. The EU

⁷¹ European Parliament, 2021, para. 18.

⁷² Machi, 2022.

⁷³ European Commission, 2016b, p. 8.

⁷⁴ Mölling, 2013, pp. 2–3.

has devised a series of financial incentives to overcome Member States' reluctance to collaborate.

3.1. *Funding cooperative spending*

Recently, there has been much focus on cooperative spending by EU Member States, with the aim of leveraging economies of scale, covering gaps and avoiding duplications.⁷⁵ Although this is not a novel concept, it needs to be revisited, considering the reluctance of Member States to cooperate. As per the CARD Report of 2022, cooperative spending in the second CARD cycle (2021–2022) as compared to the first (2019–2020), dropped from 19% to 18% of all investments in defence programmes.⁷⁶ The percentage of collaborative defence equipment procurement of total defence equipment procurement is even lower, being at its lowest in 2020 at 11%.⁷⁷ This is contrastive from the 35% benchmark to which the EU Member States agreed to.

To reinforce EDTIB, Member States agreed on a more hands-on approach to cover the gaps. Therefore, as a consequence of Russia's invasion of Ukraine, the European Council considered it necessary to advance a budget regulatory proposal. The proposal for establishing European Defence Industry Reinforcement through the Common Procurement Act (EDIRPA) was advanced in July 2022. It aims to address 'the EU's most urgent and critical defence capability gaps and incentivise the EU Member States to procure defence products jointly'.⁷⁸ Through this, the European Council aimed to increase defence spending and make it more efficient. In a sense, this is also meant to be a response to the criticism often voiced against European members of NATO that they are heavily reliant on the United States for their security and are unwilling to increase their defence spending. The envisioned increase in spending through EDIRPA should result in more efficiency. Efficiency in this area means conducting collaborative investments in defence programmes.⁷⁹ This ensures that states receive *more bang for their buck*.

With this regulation, the EU proposed a funding scheme to encourage joint purchases, making available a budget of 300 million euros for this purpose until the end of 2025.⁸⁰ This instrument is meant to address the 'most urgent and critical defence product needs, especially those revealed or exacerbated by the response to Russian aggression against Ukraine'.⁸¹

75 This was a major topic already in 2016, see: European Commission, 2016a.

76 European Defence Agency, 2022a, para. 22.

77 European Defence Agency, 2022b, p. 16.

78 Clapp, 2023.

79 A priority mentioned in the 2022 EU *Strategic Compass*, as well as the *Versailles Declaration* of March 2022.

80 European Parliament, 2023; *Regulation (EU) 2023/2418 of the European Parliament and of the Council of 18 October 2023 on establishing an instrument for the reinforcement of the European defence industry through common procurement (EDIRPA)*, 2023.

81 Article 7(1)(a) of EDIRPA.

Member States that want to participate in procurement under EDIRPA must adhere to a few ground rules. Joint purchases must be made in the form of consortia involving at least three Member States. The spending scheme includes provisions akin to requirements of local content. Contractors must be established and have their executive management structures either in the EU or Iceland, Liechtenstein or Norway (the so-called associated countries). Contractors must not be subject to control by a non-associated third country or entity. Derogation under this requirement can only be permitted under strict guarantee from those who request it. Components originating in the EU and associated countries must account for at least 65% of the end-product costs. Contractors must also use facilities and resources based in the EU or an associated country, except if producers do not have the appropriate infrastructure in the prescribed locations.

The EDIRPA also sets a cap on the contribution, at 15% of the total funds made available under it, and at 20% of the estimated value of the procurement. This should allow for the distribution of funds across more projects, which, in light of the budget made available under EDIRPA and the costs associated with defence procurement in general, would otherwise run the risk of being absorbed by a single project.

As alluded to, EDIRPA may be criticised for the lack of ambition reflected in its budget. The 500 million euros envisaged in the initial proposal and the 1 billion euros proposed by the European Parliament would also have been a far cry from what is needed in this field but would have certainly been more than the 300 million euros finally agreed upon. As a pilot project, it may be appreciated for what it is attempting, which is to bring Member States closer in terms of their defence procurement priorities, bringing with it all the benefits of such cooperation: consolidation, better access to products and enhanced interoperability among allies. While its objectives of enhancing adaptation to structural change and ramping up manufacturing capacity would undoubtedly benefit EDTIB because of its budget, it is doubtful that EDIRPA will be able to accomplish them. Such doubts were also expressed by the European Economic and Social Committee (EESC), which was entrusted to provide an advisory opinion on the proposal. The EESC stated that the initiative was “rather weak” as an industrial policy instrument.⁸²

To achieve the objectives of EDIRPA, the regulation mandates that the work of the Defence Joint Procurement Task Force and that of the Strategic Compass for Security and Defence be considered.⁸³ With an emphasis on covering urgent capability gaps, the European Commission and EDA proposed focusing on three important tasks: coordinating procurement, replacing legacy systems and reinforcing air and missile defence systems. For this purpose, they proposed establishing a Defence Joint Procurement Task Force.⁸⁴ As a result of its work, the Task Force identified a number of areas in which joint procurement should be considered: (i) medical equipment

⁸² EESC Opinion, 2022, paras. 1.3, 3.6.

⁸³ Article 3(2) of the EDIRPA Regulation.

⁸⁴ European Commission, 2022, pp. 7–8.

and supplies; (ii) chemical, biological, radiological and nuclear individual protection equipment; (iii) anti-tank systems and missiles; (iv) soldiers' equipment and radios; (v) ammunition, explosives, mortars and multiple launch rocket systems; (vi) missiles, air defence, man portable air defence systems and bombs; and (vii) small arms.

While these efforts are definitely welcome, EU funding and common procurement programmes such as EDIRPA bring in a new set of political challenges. It must be noted that *protectionist* conditions are not well received by allies, such as the United States. While it has been calling for an improvement in EDTIB, the United States has previously criticised efforts aimed at its exclusion from such programmes.⁸⁵ The American Chamber of Commerce also expressed similar criticism regarding EDIRPA.⁸⁶ Nevertheless, considering the number of F35 fighters recently acquired by European NATO members, EDIRPA could hardly weaken the American defence industry.

Another potential conflict may arise between political will and legal possibilities. The EU must adhere to several rules at its core. Article 41(2) TEU does not allow for the use of the common budget for 'expenditure arising from operations having military or defence implications (...)' However, where there is a will, there is a way, and a way has indeed been found. Therefore, EDIRPA was drafted on the basis of Article 173 TFEU, which sets out rules for enhancing the competitiveness of the European industry, in this case, fostering the competitiveness and efficiency of EDTIB.⁸⁷ Despite this apparent limitation, there are now several spending schemes that are active, aiming, among others, to enable defence-related research and development (R&D),⁸⁸ common procurement of defence-related products and the development of dual-use items and technologies. Off-budget collaboration is not limited to Article 41. However, other programmes must adhere to stricter rules. For this reason, EDF, which represents the replacement of the previous Athena mechanism, now focuses on promoting cooperation, as well as research and development, whereby novel equipment may only be funded up to the prototype phase.

Beyond the more urgent tasks covered by rapid joint procurement efforts, the European Commission proposed establishing an incentive system to serve its purposes over a longer period. The European Defence Investment Programme (EDIP)⁸⁹ establishes rules for forming a European Defence Capability Consortium for joint procurement, which would benefit from VAT exemption.⁹⁰ Despite the urgency of

85 *US warns EU over "poison pill" defence plans*, 2019.

86 American Chamber of Commerce to the European Union, 2022.

87 Article 3(1)(a) of the EDIRPA Regulation.

88 This is especially important as research and development spending did not follow procurement spending in recent years. Cf. Tigner and Landriani, 2023.

89 Details of the project can be found on the EESC's webpage. [Online]. Available at: <https://www.eesc.europa.eu/en/our-work/opinions-information-reports/opinions/european-defence-investment-programme> (Accessed: 9 January 2024); see: *European Defence Investment Programme*, no date.

90 European Commission, 2022, p. 10.

implementing such schemes, negotiations tend to drag on, which increases delays in obtaining the envisaged results.

The EU demonstrates that it is ready to go beyond its own limits, whether legal or financial, and determine ways to tackle short-term urgencies and initiate long-term plans. Such programmes aimed at harmonising Member States' defence expenditures, ramping up production and boosting innovation have mushroomed in recent years. The centre of this is the EDF. It has a budget of almost 8 billion euros, which is made available for collaborative projects in R&D during 2021–2027.⁹¹ In 2019, a two-year programme was launched called the European Defence Industrial Development Programme, aimed at supporting competitiveness and innovation capacity in the EU's defence industry.⁹² As a short-term instrument, EDIRPA is not meant for industry development but rather to facilitate procurement coordination, maximise economies of scale and avoid duplication and competition where supply is limited.⁹³ The EU also has institutions aimed at boosting innovation and industry development, the most important of which are the EU Defence Innovation Scheme and the Hub for EU Defence Innovation, with programmes such as Galileo targeting defence industrial development. In addition to this list, NATO's Science and Technology Organization and programmes made available via NATO's Innovation Fund and its support programme, the NATO Defence Innovation Accelerator for the North Atlantic, also support defence innovation. As a direct consequence of Russian aggression against Ukraine, the EU used the European Peace Facility (EPF), an off-budget fund, to reimburse Member States for ammunition donated to Ukraine, fund joint procurements and help ramp up production capacity.⁹⁴ The Act in Support of Ammunition Production, agreed upon in 2023, and based on Article 173 TFEU, was organised to accelerate joint procurement and deliver one million rounds of artillery ammunition to Ukraine in a year.⁹⁵ In the context of the ongoing war on its borders and going beyond the previously mentioned emergency measures, in March 2024, the European Commission unveiled its first European Defence Industrial Strategy (EDIS)⁹⁶ and proposed EDIP.⁹⁷ These are aimed at bolstering the EU's security and defence preparedness, proposing that Member States 'invest more, better, together, and European'.

Opportunities abound for companies, from startups, through SMEs, to large enterprises. While the above listing does not attempt to present an exhaustive account of all funding programmes, there are actually numerous programmes. However, funding appears to be meagre, when compared to the astronomical amounts usually

⁹¹ See: European Commission, 2021a.

⁹² See: *European Defence Industrial Development Programme (EDIDP)*, no date.

⁹³ European Commission, 2022, p. 1.

⁹⁴ *European Peace Facility (EPF)*, no date.

⁹⁵ *Act in Support of Ammunition Production*, no date.

⁹⁶ *European Defence Industrial Strategy*, no date.

⁹⁷ *European Defence Industry Programme*, no date.

discussed vis-à-vis regular defence spending efforts. However, neither the number of programmes nor the amount of funding at their disposal are adequate for addressing the most severe problem faced by governments in the defence procurement area: low production capacity. While accessing existing funding opportunities has a certain duration, delays are even more significant in terms of delivering on the money that is thus spent. Consequently, after providing programmes and funding, a new challenge appeared, which was a result of the fewer number of purchases induced by years of reduced spending.

In addition to the general challenges affecting the entire economy, such as inflation and shortages in the supply of critical raw materials,⁹⁸ there is also a specific lack of capacity in terms of meeting demands for high volumes of production. As previously mentioned, the defence industry must survive for years with underfunded defence budgets. This implies that many companies have reduced their output capacities and lack the resources to meet the demands at the pace required by current events. Furthermore, complex regulatory and administrative structures are ill-prepared for the quick ramp-up in spending. An example from Germany, a country widely regarded as highly competent, illustrates how difficult this can be. Despite the unprecedented political will demonstrated when the German Chancellor announced the “Zeitenwende”, and a ramp-up in military spending with a 100 billion euro special fund, the challenges to acting expeditiously in spending that money have proven too great.⁹⁹ Additionally, a special law was adopted to accelerate procurement processes.¹⁰⁰ Although a temporary solution, it was noted that this law reduces both transparency and competition guarantees in defence procurement and may be in violation of the EU’s DPD.¹⁰¹ This only serves as an example to point out a wider critique that is often placed against regulation in general, and in this case against defence procurement rules in particular, that “a more efficient” procurement regulation naturally implies compromises in the area of transparency and competition rules. Exactly the opposite of what the EU attempted through the “Defence Package”. This is just a more recent iteration of the limited implementation of the EU’s regulatory framework in Member States’ domestic regulation, whereby a deficiency in harmonised regulatory integration effectively hinders the envisioned EU-wide cooperation.¹⁰²

Statistics also show an increase in funds earmarked for defence spending. Less developed Member States, typically in Eastern EU, feeling more of a threat from the East, have also increased defence spending. However, another dimension of lack of capacity must be addressed: gaining access to the previously mentioned funding and development support schemes. This discrepancy was confirmed by the results of the 2021 and 2022 EDF calls for proposals.¹⁰³ This issue can be addressed in several

98 Council of the European Union, 2023.

99 Knight, 2023.

100 *Bundeswehrbeschaffungsbeschleunigungsgesetz vom 11. Juli 2022 (BGBl. I S. 1078)*, 2022.

101 See also: *A Critical Assessment of the Bundeswehr Procurement Acceleration Act*, 2022.

102 The difficulty in cooperation frustrates military officials, cf. Siebold, 2023.

103 As shown in: European Defence Fund, 2022; and in: European Defence Fund, 2023.

ways, such as the inclusion of incentives in calls for proposals, as is being done with SMEs, with consortia that include first-time participants eligible to receive extra points. In this way, more experienced companies forming consortia will be incentivised to include first-time participants, who will, in turn, gather experience for future rounds of funding. One may also envision special criteria modelled on Horizon Europe Widening, which is also aimed at boosting research and development in Central and Eastern Europe.

3.2. Focus on SMEs

A number of funding schemes expressly refer to SMEs, in an area that is dominated by big players. Their dominion appears logical, and is even necessary in a field of such high sophistication as defence manufacturing. However, the funding programmes rightly recognise the role to be played by SMEs, and it fits into the discourse, which states that ‘it is hard to develop new things in big organisations’, and that ‘[n]ew technology tends to come from new ventures – startups’.¹⁰⁴

Defence procurement disproportionately favours large players, with data suggesting that SMEs are less successful in winning contracts under DPD than under general EU public procurement.¹⁰⁵ SMEs tend to be increasingly nimble and creative, and hold much potential for innovation. However, weapons systems and, consequently, the defence industry have become highly complex, making it difficult for smaller players to participate. At this level of sophistication, it is difficult for a smaller company to produce a stand-alone product. The defence industry in general, and SMEs in particular, find it challenging to attract financing from private sources. It is recognised that SMEs hold significant potential for innovation, but it also turns out that around 80% of R&D projects fail.¹⁰⁶ This renders such projects highly risky to investors. Further disincentives for private financing come from other EU regulatory priorities such as green financing rules and the application of Environmental, Social and Governance criteria.¹⁰⁷ The cumbrance represented by having to comply with such regulation, may seriously affect the willingness of private sector funds to invest in the defence industry.

Beyond R&D for innovation, one of the methods for SMEs to thrive is to latch on to the manufacturing stream of an original equipment manufacturer and become a sub-supplier. According to research conducted by the European Commission, there are around 2,500 SMEs in the EU ‘operating in the multi-layered and often trans-border defence supply chains’. These SMEs ‘serve the land (39.6%), air (30.5%), maritime (18.7%), cyber (7.8%), and space (3.4%) defence domain customers’.¹⁰⁸

104 Thiel and Masters, 2014, p. 10.

105 European Parliament, 2021, para. 28.

106 Maulny et al., 2023, p. 3.

107 European Defence Agency, 2023, paras. 13–14. See also: Maulny et al., 2023, pp. 3–5.

108 European Commission, 2022, p. 5, n. 17.

However, subcontracting is difficult, and obtaining certification incurs increased costs.¹⁰⁹ In breaking down “disproportionate and unfair disadvantages”, some States have moved towards solutions, by adopting public policy tools to facilitate SMEs’ access to public defence and security contracts.¹¹⁰ Funding programmes may also incentivise innovation and SME participation.¹¹¹

Recognising the inherent disadvantages affecting SMEs in the defence sector, EU funding programmes concentrate on providing smaller companies with more opportunities. There was no lack of willingness to participate. The EDF programmes were highly sought after in 2023, with good uptake in programmes targeting SMEs.¹¹² The consortia formed to access EDF funds may also cascade such funds to SMEs and startups. In the case of EDIRPA, the call incentivises procurement of equipment, the manufacturing of which takes place with the participation of SMEs or mid-caps. Furthermore, EDF offers business coaching to SMEs for two years, providing guidance on overcoming business challenges and reducing the time from research to development or from development to the market. Despite these efforts, SMEs receive only 20% of actual funding.¹¹³

Considering that security of supply concerns have led procurers to focus on equipment that can be obtained from national sources, SMEs find themselves in an even more difficult situation when it comes to breaking outside their home markets. Accordingly, the European Commission published a set of proposals to enhance cross-border market access for SMEs.¹¹⁴ However, SMEs are best served by finding new market sectors. This may be the reason why many SMEs tend to gravitate towards the area of dual-use items, which enables them to extend their clientele beyond the narrower defence sector. This presents additional challenges, as synergies between civilian and military products may result in vulnerability in the supply chain. In a field where security of supply is a tantamount objective, industry players must be aware of their supply chains and solve possible dependencies before they pose a problem.

Focusing on dual-use items may also provide companies with more avenues to obtain financing from public sources. The European Commission acknowledged this opportunity when it launched public consultations via a recently published white paper aimed at exploring opportunities to shift resources to support R&D of technologies with dual-use potential.¹¹⁵ Dual-use projects may benefit from European

109 European Parliament, 2021, paras. H–J.

110 Masson and Martin, 2015, pp. 38–39.

111 Greenacre, 2023.

112 Record high number of proposals received in the 2023 round of the European Defence Fund; Defence Industry Europe, 2023.

113 See statistics in: European Defence Fund, 2022; and in: European Defence Fund, 2023.

114 *Commission Recommendation (EU) 2018/624 of 20 April 2018 on cross-border market access for sub-suppliers and SMEs in the defence sector*, 2018.

115 European Commission, 2024. Previously, the Commission also published the Action Plan on Synergies between Civil, Defence and Space Industries, see: European Commission, 2021b.

Investment Bank (EIB) financing.¹¹⁶ Such financing could be tied into the EIB's aim to finance 'projects for developing less-developed regions', as per Article 309(a) TFEU. Several Member States have called on EIB to invest in core defence projects, but this would require an amendment to its rules.¹¹⁷ Further funding opportunities lie in instruments such as the Important Projects of Common European Interest or CASSINI, which may be appropriate for financing the R&D of dual-use technologies.

A comprehensive empirical study may reveal how much funding programmes have accomplished in their quest to de-fragment defence markets and how much space they have actually created for SMEs. Additional questions regarding the possibility of circumventing the conditions for accessing funding opportunities should be explored. For now, it appears that protectionist practices in defence procurement are paradoxically maintaining fragmentation in the defence industry and providing many SMEs the lifeline they need to survive in this market. It is possible that without States' willingness to support their domestic defence industry, SMEs would not have much of a chance in the face of market competition.

4. Protectionist procurement – Offsets trending

States often turn to different techniques to ensure that the bidder they favour wins a particular tender. Such practices include the direct awarding of contracts, the organisation of by-invitation-only bids (thus avoiding competition) or even the tailoring of tender specifications in a manner that severely narrows the competition. The limited use of TED, as previously mentioned in the context of DPD, and the generally-restricted circulation of advertisements, also serves to exclude some bidders. The defence sector is markedly secretive; however, these techniques are generally regarded as manifestations of corruption.¹¹⁸ However, in the field of defence procurement, the corruption and anti-corruption rhetoric seldom emerges.¹¹⁹ The preferred term is protectionism. This has more to do with the specifics of the defence industry's ownership structure than anything else. State ownership in the defence sector's national champions is an important driver of such *protectionism*.¹²⁰

As previously mentioned, a factor that is highly valued in defence procurement is the security of supply, in terms of inputs related to a country's defence capabilities. Securing predictability in the supply chain is an important driver of the ongoing recalibration of international trade and investment regimes. While the trend

116 As also noted in: European Commission, 2017a.

117 Foy, 2024.

118 Cf. World Bank Group, 2010, p. 7.

119 Although it is not completely lacking, cf. OECD, 2016, p. 3.

120 Czibik et al., 2020, p. 5.

in the general economy towards re-shoring and friend-shoring is a consequence of securitisation occurring in more areas of the economy in the defence sector, this is not a novel topic. Beyond friend-shoring, security of supply may be considered optimal when the production of inputs moves within the borders of the procurer state. Therefore, controlling the means of production is essential. Therefore, the market logic of obtaining *the best value for the money* is given a new dimension and attracting suppliers into offset arrangements and joint venture agreements may receive priority. Procurer states use these tools to attract investments and link autochthonous companies to supply chains through local content requirements. Such practices may not be compatible with short-term or urgent procurement plans because they tend to slow down the process. However, they are quite adequate for the long-term plan of building up the domestic defence industry, often with the participation of the state as part-owners.¹²¹

Experts describe a strong defence industry as characterised by the presence of a 'large number of privately-owned firms, free entry to the market and competitively determined fixed-price contracts', where 'profits attract new entrants and losses lead to exits'. They contrast this with what would be considered as a weak defence industry, which is one that is 'characterised by state-owned firms, subsidies, protectionism, and cost-plus contracts'.¹²² Considering the extensive use of offsets, it is difficult to apply market logic fully to defence procurement.

A generic term, mostly familiar to experts in the field of public procurement, an *offset* is a form of compensatory procurement requirement, formulated to offset the expenses associated with acquiring defence equipment in favour of the domestic economy of the procurer.¹²³ This often takes the form of a return commitment from a supplier to engage in industrial cooperation. A simple perspective is that offsets are basically 'those goods and services on which a government chooses to place [this] label'.¹²⁴

Offsetting has become a major component of the defence procurement policy aimed primarily at promoting the development of the procurer's national defence industry. Offsets typically appear in two forms: direct and indirect.¹²⁵ Direct offsets are contracts that directly tie into procured defence products. For example, acquiring helicopters may come with an obligation to set up servicing work or production of components within the procuring country. Through this, a country not only acquires equipment, but also creates jobs, develops competence and arranges for the transfer of technology related to the acquired equipment. Indirect offsets involve bundling the procurement deal with an incentive that is completely unrelated to the acquired products. In this regard, the acquisition of helicopters from a particular supplier may

121 Cf. Schroeder et al., 2020.

122 Hartley, 2013, pp. 4–5.

123 Cf. Csécsy et al., 2015, pp. 29–30.

124 For more definitions, see: Ungaro, 2013, pp. 4–5.

125 Cf. Martin, 1996, p. 3.

be part of a larger deal to establish handgun production in a procurer's country. Furthermore, scholars distinguish between three categories of offsets: countertrade, whereby the seller purchases goods and services from the buyer's territory; local content requirement, involving a commitment to the source part of the contract from the buyer's territory; and the bundling of requirements, whereby the buyer conditions its purchase on the provision of other products or services.¹²⁶ Of these three categories, the local content requirement presents the most interest, as it often takes the form of establishing facilities through foreign direct investment, joint ventures and co-production arrangements. Economists consider these to be the most advantageous types of offsets.¹²⁷ Joint ventures are usually long-term agreements that aim to build defence and industrial capabilities within a country. Such agreements usually involve four actors: manufacturer, manufacturer's government, contracting government agencies and local defence champion.¹²⁸

The scale of investment resulting from the offset agreement depends on two major factors. On the one hand, the offer of the procurer states its financial capacity and what it is able to offer in terms of a specialist workforce and infrastructure. However, there may be significant restrictions on how much intellectual property, technology and the home state of an original equipment manufacturer allow it to share. Without delving into further details on these aspects, it may be concluded that investments pursuant to offsets are limited on these fronts; consequently, such arrangements range from servicing to component manufacturing and supply, through final assembly, to licenced production and full domestic production of a weapons system. Therefore, governments must be realistic about the market potential of compensatory arrangements and pay attention to the selling potential of a particular product. They must also be realistic about their own capacities and settle for producing a component instead of attempting to operate a full weapons system plant if they lack experience. However, these business considerations require detailed planning and time-consuming negotiations.¹²⁹

Viewed in its entirety, it should be easily understood why procurer states perceive so much advantage in obtaining at least some form of offset. It then becomes evident why they use existing loopholes and disregard the EU's insistence on the application of market logic. The offsets are useful in various settings. They may help with the political justifications for military spending. They are also an efficient means to building long-term relationships between the procurer and the supplier or supplier's home State. For States, it is a tool for ensuring security of supply by localising military industrial production. For companies, it is a way to ensure that they win major supply contracts. These are some of the factors that fuel enduring

126 Markowski, Hall and Wylie, 2010, pp. 139–140.

127 Martin, 1996, pp. 24–25.

128 Schroeder et al., 2020, p. 3.

129 Detailed analysis of a major procurement contract implicating detailed offset requirements is contained in: Seguin, 2007.

support for these arrangements.¹³⁰ The creation of jobs may be a good justification for increasing defence spending, but the development of an advanced defence technological and industrial base is necessary to gain the ability to absorb and maintain complex military equipment manufacturing potential.¹³¹

Although these practices distort competition, the reasons presented above make a compelling case as to why less-developed Member States, especially, will likely continue to use offsets. As a matter of policy, France and Germany do not allow offsets. However, they can afford such policies as they dispose of mature defence industries. Large actors in the defence industry also work together on several successful projects.¹³² This perpetuates underdevelopment in the defence industries of Member States on the periphery. The room for manoeuvre of these Member States is further limited by the fact that legislation and policy requiring offsets more generally are considered to be in violation of EU law by the European Commission.¹³³ The DPD does not mention offsets expressly; however, circumscribing them forbids such practices. However, this extends only to offsets in the indirect form. Direct offsets are nevertheless possible when the exemption under Article 346 TFEU is used in a justified manner during a particular procurement, that is, the exemption is necessary and proportional. It must be highlighted though, that the offset itself must also be justified under Article 346 TFEU exception.¹³⁴ Furthermore, direct offsets involving R&D are expressly carved out of DPD.¹³⁵ In terms of EU law, offset requirements may violate the fundamental freedoms and basic principles laid down in treaties. Specifically, offsets may violate the freedom of establishment, free movement of goods and services, principles of equal treatment, non-discrimination and transparency. Therefore, they are considered incompatible with the Treaty and DPD. This viewpoint was clarified by the European Commission's Directorate General for Internal Markets in its Guidance Note on Offsets, which, while non-binding, cautions procurer Member States that the use of offsets may constitute an infringement of the Treaty.¹³⁶ The Commission also took action on this basis, launching infringement procedures against trespassing Member States while also looking to dissuade others from using offsets.¹³⁷ Despite EU opposition, offsets continue to be in use. As noted in a research paper published in 2015, '[p]olicies to reform offsets remain purely cosmetic.'¹³⁸ A 2016 report of the European Commission concluded that offsets were

130 Jovicic, Strang and White, 2021.

131 Ibid.

132 *Britain, Japan and Italy sign advanced fighter jet programme treaty*, 2023; Meier, 2017.

133 Directorate General for Internal Markets and Services, 2016, paras. 21, 26.

134 Ibid., para. 23.

135 Recitals 34, 55 of the *Defence Procurement Directive*.

136 Directorate General for Internal Markets and Services, 2016, in particular para. 26.

137 European Commission, 2018.

138 Masson and Martin, 2015, p. 40.

in use and their frequency only “marginally decreased”.¹³⁹ This is also confirmed by the annual report to Congress on offsets in the defence trade prepared by the Bureau of Industry and Security of the U.S. Department of Commerce.¹⁴⁰

It must also be highlighted that the continued application of protectionist procurement policy has had a lasting effect on the fragmentation experienced in the European defence industry. EDTIB already has numerous gaps and duplication of capabilities.¹⁴¹ While cooperative procurement has many advantages, it seems unable to outcompete the advantages that states see in protectionist procurement. One may argue that synchronising procurement efforts at the EU or NATO level, considering their size and divergence in their members’ interests, is more difficult. The current crisis also reveals acute differences in the threat perceptions of NATO members.¹⁴² Even in smaller alliances, such as the Nordic Defence Cooperation, where a convergence of interests may appear easier to achieve, efforts to synchronise defence procurement and industrial development have yielded limited results.¹⁴³

Protectionist procurement generally contributes to major distortions in the defence sector. Therefore, it is questionable whether many European defence companies would be able to compete under regular rules. Defence companies benefitting from “close relations with national governments” is a matter that the European Commission drew attention to in a document proposing solutions that drive efficiency in cooperative procurement.¹⁴⁴ However, clinging to the application of free-market principles and regular competition policies may not be a way towards bolstering EDTIB. However, the tools used thus far have not had a significant effect. Operating the defence industrial development according to market logic would also have a small number of *winners*, possibly leaving numerous Member States dissatisfied. Such a policy would surely be advantageous for Member States with strong defence industries. In such cases, pushing for a more market-based approach to defence procurement would see large companies expand further, swallowing up smaller players. Expanding protectionism to the European level would, in turn, serve to exclude successful U.S. and South Korean companies, which have proven to be relatively competitive at this time of crisis. Many Member States, especially those that are increasingly threatened by their proximity to Russia, may not be best served by such a protectionist approach to open strategic autonomy. Their continued reliance on the United States has been reiterated from time to time, among others, through

139 *Report from the Commission to the European Parliament and the Council on the implementation of Directive 2009/81/EC on public procurement in the fields of defence and security, to comply with Article 73(2) of that Directive*, 2016, p. 5.

140 U.S. Department of Commerce, 2023.

141 European Commission, 2017b, p. 8.

142 In a recent survey conducted in several European countries with elections in 2024, the question regarding issues that changed peoples’ views of the future, shows a definite divide in terms of countries’ proximity to Russia. Cf. Krastev and Leonard, 2024.

143 Dahl, 2021, pp. 174–175.

144 European Commission, 2022, p. 5.

the acquisition of defence-related equipment. Prioritising defence cooperation in the NATO framework, as opposed to other European frameworks of collaboration, has always been a priority for these EU Member States. This was also demonstrated by Poland's participation in PESCO, which from the start was conditioned on the primacy of NATO planning.¹⁴⁵

5. Concluding remarks

In consonance with the case of a collectivised economy with which many Central and Eastern European countries have had extensive experience, collectivised defence and security attract a degree of free-riding and passive attitudes similar to those provoked by *non-ownership*. Structures built for collective action have often failed to deliver more cooperation on defence despite their expressly-stated roles. These organisations must nudge their passive members towards more action and more efficient cooperation. The promise to meet the 2% spending on defence agreed upon at the 2014 NATO Summit in Wales should be met by 2024. Although increased spending is welcome, there is not enough cooperation amongst EU Member States.¹⁴⁶

Collective defence planning was considered essential in the early days of NATO and was part of its first ever Strategic Concept published in 1949.¹⁴⁷ The EU has since placed more emphasis on it than its Member States. This also placed the EU on collision course with U.S. interests. EU–NATO and EU–U.S. relations represent additional dimensions to this complex web of interest.¹⁴⁸ ‘We will stay transatlantic and become more European’, was the promise of Ursula von der Leyen during her candidacy.¹⁴⁹ The United States has not been shy about voicing its criticism of the collaborative approaches to defence spending envisaged by the EU, fearing the potential effects of cutting out U.S. companies from spending schemes.¹⁵⁰ As revealed by a former chief executive of EDA, the United States ‘aggressively lobbied against Europeans’ efforts to develop their defence industrial and technological base’.¹⁵¹ However, a strong EDTIB would serve United States interests as much as it would serve European interests, potentially freeing up the much-needed United States resources to focus on other priorities. Consultations on the matter via the new administrative arrangement between the U.S. Department of Defense and the EDA may bring

145 Cf. Meier, 2017.

146 Monaghan, 2023.

147 Under “Cooperative Measures” in Section 8 of the 1949 NATO Strategic Concept.

148 As also noted by Míszlivetz, 2023, pp. 161–163.

149 von der Leyen, 2018, p. 19.

150 Emmott, 2019.

151 Witney, 2019, p. 3.

about actual results in bridging the gap.¹⁵² Enhancing Trans-Atlantic cooperation is critical, especially at this time, when, in addition to the military, academics¹⁵³ and politicians¹⁵⁴ are also calling for switching to a war economy in Europe. However, it is also crucial that decision makers ensure that building up EDTIB would be done in an equitable manner.

The EU has attempted to introduce market logic to defence procurement, but this would leave Member States with less-developed industries at risk of dismantling their defence industries. Maintaining competitive rules in the defence sector to ensure “fair competition” cannot be an end in itself. The end game must have a better defence industry, improved EDTIB and a capable defence force. However, additional factors such as development and cohesion should not be overlooked. Clinging to the classic principles of competition may not always be conducive to this; it may not be the best means for accomplishing the end game. This is also a thinking in the old paradigm of free trade: being more efficient, cutting costs and producing better and cheaper products would ultimately leave Europe’s middle-income economies with difficulty.

The crisis now unfolding in Ukraine has presented an opportunity for the EU to step up in the area of defence industrial cooperation and deliver on its promises of cohesion. The EU missed its chance, and this is probably best demonstrated by news of various defence acquisitions. Member States filled gaps in their defence equipment requirements through off-the-shelf purchases, despite the CARD warning that such actions would further fragment and weaken EDTIB. The urgency of the situation served as a cover for the use of old, ingrained protectionist procurement methods.¹⁵⁵

At the Heritage Foundation in Washington D.C. on 31 January 2024, NATO Secretary-General Jens Stoltenberg pointed out “some serious weaknesses” and gaps in the production capacity of NATO members. He highlighted the advantages of economies of scale and that NATO has an open defence market, which is advantageous to the United States. However, all NATO members should experience these advantages. Currently, the EU efforts to build up the EDTIB appear to be protectionist, and the U.S. Buy American Act has similar effects. In addition, without concrete policies aimed at bringing the advantages of this “open market” to less developed members, these members will continue to use offsets, and engage in protectionism.

Economic interests of Member States must align with defence priorities for EU-wide defence cooperation to be integrated in a legislative framework that is conducive to defence industrial development. EU defence industrial policies must

152 The text of *the Administrative Arrangement* signed on 26 April 2023. [Online]. Available on the website of the European Defence Agency: <https://eda.europa.eu/docs/default-source/documents/signed-aa-eda-us-dod-2023-04-26.pdf> (Accessed: 15 January 2024). See also: European Defence Agency, 2023.

153 VoxEurop, 2023.

154 Bezat, Pietralunga and Vincent, 2023.

155 Bedi, 2023.

focus on the fair and equitable distribution of such developments. For less-developed Member States, it may be better to maintain open markets in the EU and not be coerced into an exclusively European protectionist market dominated by EU players, as such an arrangement runs the risk of locking in existing inequalities.

Despite the apparent willingness of EU Member States to work together on defence, collective agreements regarding cooperation in spending or R&D have proven to be nothing more than hypocrisy. Member States' governments continue to pursue protectionism and favouritism in the area of defence; they may be right in doing so.

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