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How are defence companies responding to EU defence and security market liberalization? A comparative study of Norway and Sweden

Fulvio Castellacci, Arne Martin Fevolden and Martin Lundmark

ABSTRACT A new European Union Directive (Defence and Security Procurement Directive 2009/81/EC) intends to liberalize the European defence market. This article investigates whether this Directive leads to a more liberalized European defence market and how the defence companies respond to these changes, by carrying out a set of interviews with a selected sample of some of the most important defence contractors in Norway and Sweden. The article points out two main results. (1) The defence companies believe that the liberalization of the European defence market will at best be partial and fear that the new regulations might end up favouring the larger nations (e.g., Germany, the United Kingdom and France) at the expense of the smaller countries (e.g., Norway and Sweden). (2) The companies' scepticism and response to the Directive vary according to the defence industrial policy regime they are part of and their position in the defence industrial value-chain.

KEY WORDS Defence industry; EU; export; industrial policy; liberalization; security policy.

1. INTRODUCTION

The European Union's Defence and Security Procurement Directive (2009/81/EC) is currently being transposed into national law by European Union (EU) and European Free Trade Association (EFTA) member states. The intention behind the Directive is to increase the trade of defence and security equipment within the European Economic Area (EEC) and thereby encourage competition, limit duplication and eventually strengthen the productivity and competitiveness of the European defence sector. Although the actual impact of the Directive is still uncertain, it is likely that most member states will find it harder to maintain their existing defence industrial policies – whether these policies take the form of import barriers to protect their domestic industry from

foreign competitors or offset (counter-trade) requirements to ensure that their domestic industries have access to foreign markets (Blauberger and Weiss 2013; Hoeffler 2012). Nevertheless, the Directive might not affect each member country in the same way or to the same extent. Some authors have already begun to speculate that the Directive will impact member countries differently according to the size of their national defence markets and the strengths of their defence industrial base (Edwards 2011: 12).

To understand the possible effects of market liberalization, it is important to investigate business firms' response to this policy change. Are defence companies adjusting their business and internationalization strategies to prepare to compete in a more open European defence market in the future? This question is fundamental, because the impact that the Directive will have depends to a large extent on private firms' reaction to the new policy regime. The macro policy change will be more effective if micro agents (companies) internalize and adopt it rapidly.

This study has investigated this topic by carrying out a series of in-depth interviews with some of the most important defence contractors in Norway and Sweden, and asking them questions about how they foresee the effects of the new EU Directive and what strategies they have adopted to take advantage of or mitigate these effects. The study has investigated some major companies from the two Northern European countries, firms that not only reflect the diversity of the two defence sectors but also account for a large share of their respective countries' defence-related value-added, employment and export.

Previous efforts to liberalize the European defence markets have met with limited success (Keohane 2008; Schmitt 2005), and this article will make use of the defence companies' unique insights to see if the new EU Directive promises to be more successful. Our specific objective is to investigate how country-specific policy environments shape the companies' views of the Directive. By comparing large-, small- and medium-sized defence companies in Norway and Sweden, the article will see whether the companies' perception and strategies are influenced by the defence industrial policy regime of which they are part and their position in the defence industrial value-chain.

There are two main findings in the article. The first finding is that the defence companies were quite sceptical with respect to the actual implementation of the Directive; they believed that the liberalization of the European defence market would at best be partial, and feared that the new regulations might end up favouring the larger nations (e.g., Germany, the United Kingdom [UK] and France) at the expense of the smaller countries (e.g., Norway and Sweden). The second finding is that companies' scepticism and response to the Directive varied according to the defence industrial policy regime of which they are part and their position in the defence industrial value-chain. The Norwegian companies – which enjoy stronger support from their government than their Swedish counterparts – were significantly more sceptical to the Directive and less inclined to prepare for a more liberalized defence market; and the small- and medium-sized enterprises (SMEs) – which depend less on national

defence industrial policies and have weaker internal capabilities than larger firms – viewed the implications of the Directive as less important and were less inclined to implement strategies to take advantage of or mitigate its effects.

This work extends the recent literature on EU defence and security market liberalization. Most of the recent studies on this topic have focused on the determinants of the establishment of EU law in defence-related matters, and emphasized the importance of supranational and national actors to explain the rapid establishment of the new Directive (Blauberger and Weiss 2013; Britz 2004; Guay 1997; Hoeffler 2012; Mörth 2000). Our extension of this literature is twofold. First, we shift the focus from the establishment to the implementation phase of the Directive, thus building a bridge to the compliance literature in EU studies (Falkner *et al.* 2005; Mastenbroek 2005; Treib 2008). Second, in line with the seminal account of Stone Sweet and Sandholtz (1997), we emphasize the important role of defence companies as major actors shaping the pace, future prospects and final outcomes of the liberalization process.

The article is organized as follows. Section 2 provides a brief background on the rationale for the new EU Directive. Section 3 summarizes the relevant literature. Section 4 presents our theoretical framework and hypotheses. Section 5 discusses the results of the Norwegian and Swedish cases. Section 6 provides a comparison of the two cases and highlights the main results.

2. EUROPEAN UNION'S DEFENCE AND SECURITY PROCUREMENT DIRECTIVE

The European Union's Defence and Security Procurement Directive (2009/81/EC) is one of several recent initiatives that the European countries have taken to create a more competitive and transparent European defence market (Schmitt 2009: 6). Among others, the main European arms producing nations signed in 1996 a 'Letter of Intent' to harmonize their defence market rules, and the European Defence Agency (EDA) introduced in 2006 a non-mandatory 'Code of Conduct' that should encourage the member states to open their defence markets to foreign bidders – but these initiatives fell far short of creating a common European defence market (Keohane 2008). The Directive is supposed to be a stronger political tool, since it regulates and limits the use of Article 346 of the Treaty on the Functioning of the European Union (the 'Lisbon Treaty'), an article that has enabled member states to exempt trade in defence and security equipment from the Internal Market.[1]

It is still an open question to what extent and in what form EU and EFTA member states will be able to make use of defence industrial policies after the Directive has been transposed into national law. There are, nevertheless, some defence industrial policy instruments that most likely will be affected by the new Directive – offset agreements and direct purchase without competition (Edwards 2011; Heuninckx 2011). It is common to distinguish between two types of offset agreements. When an offset agreement involves using a national defence contractor to produce part of the defence equipment that the country

procures, it is called 'direct offset'; and when the agreement involves purchases unrelated to the defence equipment that the country procures, it is called 'indirect offset'. The new EU Directive will make it difficult to request indirect offsets, but direct offset can still to a limited extent be demanded to ensure, among others, security of supply.[2] Direct purchase without competition is another policy instrument, where the government purchases defence equipment from a national defence contractor without considering offers from foreign suppliers. Although direct purchases can still be carried out under the new Directive, the member states will have to substantiate that their essential security interests are at stake.

Nevertheless, the Directive opens up for continued use of other policy instruments. For example, two or more member nations might escape from the scope of the Directive by entering into a co-operative programme (cost-share/work-share agreements[3]) for the development of a new product based on a substantial amount of research and development. The Directive also opens up some new opportunities for SMEs, by a non-mandatory Article 21 in the Directive that states that nations *may* demand up to 30 per cent of defence contracts being outsourced to other companies (Heuninckx 2011). This Article creates a possible new market for the SMEs by opening up existing supply chains.

3. THEORY

Two important strands of literature in EU studies are relevant for the conceptual framework and empirical analysis presented in this article.

3.1. The establishment of EU secondary law in defence-related matters

The literature on the EU defence equipment market and defence industrial policy has so far mainly dealt with questions about how the EU has (apparently) been able to liberalize the European defence and security market, despite several failed attempts in the past. Scharpf (1988) formulated the original 'joint-decision trap model' – a general framework that explained why it was so difficult for the EU to get its member states to support market liberalization. Specifically, this model argued that economic integration failed to advance because such supranational decision-making depended on hard-to-reach, unanimous consensus among lower-level (national) governments (Scharpf 1988: 267, 271). While the joint-decision trap model was formulated in general terms and subsequently applied to several different policy domains, the recent literature has presented some possible explanations of how the EU has succeeded in avoiding this trap and received approval for the new defence and security procurement Directive. Three distinct types of explanations have put emphasis on different levels of analysis (Blauberger and Weiss 2013: 1132–4; Weiss 2012, 2013).

3.1.1. *The 'supranational entrepreneur' approach*

This approach focuses on the European Commission (EC) as the main actor driving the integration process, and its entrepreneurial ability to negotiate and push its liberalization agenda in different policy domains. Specifically, in the recent literature on EU defence and security market liberalization, three distinct factors have been discussed: (1) 'spillover', i.e., the progressive extension of EC's policy-making activities from one domain to another (Guay 1997: 418); (2) 'framing', i.e., the ability of the EC to reframe the defence liberalization issues by reconciling the 'market frame' (economic rationale) and the 'defence frame' (national security rationale; see Mörth [2000: 183–5]); and (3) the 'push and pull' strategy, i.e., the EC's ability to strategically use judicial politics of the European Court of Justice (ECJ) in order to reach consensus and approval of the new Directive (Blauberger and Weiss 2013: 1122).

3.1.2. *The 'economic patriotism' approach*

This approach investigates more explicitly member states' own interests and agenda in promoting liberalization (Clift and Woll 2012: 308; Hoeffler 2012: 436). Defence liberalization can be explained by a shift in national attitudes – from a belief that the country's economic interests are best served through national protectionism to a belief that these benefits are outweighed by the new business opportunities granted by participating in a larger, liberalized market. Further, this approach points out that there is still considerable room for governments to provide 'hidden' forms of protectionism and industry support even in markets that are formally liberalized, and that countries will pursue these policies to varying degrees and with varying levels of success (Clift and Woll 2012: 315).

3.1.3. *The 'transnational business' approach*

This approach points out the importance of transnational actors, and in particular business companies, and their dynamic interactions with the supranational level (Stone Sweet and Sandholtz 1997). According to this view, EU integration is driven primarily by transnational firms that are interested in, and push for, the liberalization of EU markets. This creates a demand for supranational rules and regulations that EU institutions can provide. In any given policy domain, once EU rules and organizations are established, a dynamic process of interaction between transnational and supranational actors sets in, thus further supporting the need for deeper integration and hence enlarging the scope of the liberalization process. According to this view, the integration process must be understood in a dynamic framework in which business companies' internationalization interests and strategies assume crucial importance (Stone Sweet and Sandholtz 1997: 299, 305). To the best of our knowledge, this theoretical approach has not yet been applied to the study of defence and security market liberalization. Our article will take some important insights from this approach and apply it to the case of defence.

3.2. Implementation and compliance literature in EU studies

Once EU secondary law is established, the next important step is its implementation by national member states, i.e., the process by which national governments transpose EU Directives into domestic laws. In fact, as pointed out by Treib (2008: 5):

> crucial decisions that may decide on the success or failure of a particular policy are regularly taken at the implementation stage. What is more, it is far from self-evident that implementers will behave dutifully.

The literature on implementation and compliance has attracted a great deal of attention in EU studies, and it has so far proceeded along three subsequent phases (see overviews in Mastenbroek [2005], Sverdrup [2007] and Treib [2008]). A first wave of research followed a top–down approach, focusing, for example, on the administrative capability of member states to interpret and apply EU-driven legislation. A second strand of the literature followed instead a bottom–up approach and focused on the degree of fit (or misfit) between EU laws and national institutional and legal traditions, explaining the lack of implementation in terms of a possible mismatch between the two governance levels.

More recently, a third wave of research has combined insights from the previous traditions, and investigated in greater details cross-country differences in implementation patterns. Specifically, an important advance has been the observation that groups of countries vary in the way they fulfil their EU-related duties and that these groups can be divided roughly into three distinct 'worlds of compliance'. While the Nordic countries belong to a 'world of law observance', where EU directives are typically transposed fast and correctly, countries such as France and Greece belong to the 'world of neglect', where transposition is hampered by bureaucratic inertia, and countries like Germany and the UK belong to the 'world of domestic policy', where compliance with EU law depends on the fit with the political preferences of the government and other powerful domestic players (Falkner *et al.* 2005; Falkner and Treib 2008; Sverdrup 2004).

In short, this brief summary of the literature indicates two key points that are relevant to motivate our study. The first point refers to the EU compliance literature. This literature has been applied to several different policy domains, but there exists no empirical study yet on the implementation of the new EC Directive on defence and security procurement. In order to achieve a better understanding of the future prospects and expected outcomes of the ongoing liberalization process in European defence and security, it is not only important to look at the phase of *establishment* of the new EU Directive, but also to investigate the process of its *implementation* by member states, and the two-way dynamic interaction between them.

The second point refers to the importance of defence companies in this process, and particularly large international defence contractors. In line with

Stone Sweet and Sandholtz's (1997) transnational business approach, we argue that transnational actors play an important role to demand for the establishment and implementation of EU legislation to liberalize EU markets, given their interest to find new business opportunities in international markets through export and foreign direct investments (FDI). This argument is all the more relevant in such a highly concentrated market as the defence industry, in which one or a few large oligopolistic companies typically dominate each national market and have a strong influence on their respective governments.

4. HYPOTHESES

Our main argument is that the implementation of the EU Directive may lead to two distinct trajectories, depending on defence companies' response to it. On the one hand, if defence enterprises expect liberalization to bring new economic opportunities for them, they will express support for the Directive and prepare to compete openly in the European markets. This will signal to their respective governments that the Directive might be in their national interest and lend support and legitimacy to the national implementation process. When this is the case for several European countries, the EC will be able to gradually extend and expand the liberalization process within the defence and security market. On the other hand, if defence firms perceive the Directive as a threat to their market position, they will not adjust their business strategies, but rather try to convince their respective national governments to delay, suspend or bodge the implementation of the Directive. In such a situation, member states may resist the supranational pressure to liberalize, and implement the Directive only partially or slowly – decreasing the scope and effectiveness of the liberalization process.

In short, we point out the existence of a two-way dynamic interaction process between the establishment of secondary law by the EC (EU level), its implementation by member states (country level), and the response of defence companies (firm level). This argument explains why it is relevant to study companies' expectations towards the Directive and their changing (or unchanging) internationalization strategies. This dynamic mechanism is largely based upon, and extends further, Stone Sweet and Sandholtz's (1997) transnational business theory of the integration process. While Stone Sweet and Sandholtz's original account focused on the role of international firms in the phase of establishment of EU secondary law, we argue that defence companies also play an important role in the implementation and compliance phase, and thus substantially affect the future prospects and final outcomes of the liberalization process.

So, more specifically, what are the main factors affecting defence companies' response to the new Directive? When a process of market liberalization is in place, business companies decide their response to it – their internationalization and/or lobbying strategies – based on their expectations about the possible impacts that liberalization will have for their future profits and opportunities.

In turn, these expectations will be largely based on, and affected by, the national policy environment in which firms operate (current as well as past policies).

To illustrate this idea and make it more specific, we formulate two hypotheses that characterize how and why companies' response to liberalization differs. The first hypothesis (H1) concerns how different national contexts – protected versus less-protected policy regimes – affect firms' response, whereas the second (H2) refers to the different reaction that characterizes large versus small- and medium-sized enterprises.

> H1: Protected vs less-protected policy regimes. In countries where the government provides a high level of protection and domestic support for the defence industry, companies will in general be less responsive and slower to adjust to liberalization than in economies that are more open and where the government is less prone to protectionism.

To illustrate this proposition, we can contrast the cases of Norway and Sweden (to be empirically examined in the next sections). Norway has a very active defence industrial policy and the government has repeatedly expressed an explicit goal of maintaining the viability of its defence industry. Sweden, on the other hand, has discontinued many of its defence industrial policy measures and the Swedish government has expressed only little interest in supporting its defence industry. Based on these differences, it would be reasonable to expect that defence companies in Norway will in general be less responsive and slower to adjust to EU liberalization processes than the Swedish defence contractors. The Norwegian companies are used to the benefit of substantial support from their government and might have a harder time adjusting to a more liberalized policy regime; and they have a government that is prone towards 'economic nationalism', and might reasonably assume that their government will find ways of continuing to support them – even after the Directive has taken effect. The opposite is true for the Swedish defence contractors.

It is also important to notice that this hypothesis is partly in contrast with the expectation that we may derive from the EU compliance literature, according to which Norway and Sweden are part of the same 'world of law observance', i.e., that they are generally inclined to transpose EU directives fast and correctly. According to this view, we should expect defence companies in both countries to rapidly adjust to the new open and increasingly competitive market environment. By contrast, our hypothesis argues that, although it is generally the case that Norway and Sweden tend to actively comply with EU legislation, in defence-related matters national specificities and patriotic interests may be strong and explain different reaction patterns in these two Nordic countries.

> H2: Large firms vs SMEs. Large defence companies are more willing and more rapid to adjust to liberalization than SMEs, because of the greater challenges they face in the short run and the higher opportunities they foresee in the longer term.

In the defence industry, large defence contractors are typically the main beneficiary of public support and domestic protection, since they have for a long time developed and maintained a close collaboration with national defence authorities (Mowery 2010). This means that, when a process of liberalization is implemented, competition to get access to public support schemes will become more open and internationally competitive, and it will then become more difficult for large domestic enterprises to continue to play a dominant role as main beneficiary of national public support. Anticipating this possible short-term reduction in public grants, large defence contractors will adjust their expectations about market demand, and will then be forced to adjust their business and internationalization strategies in order to compensate for this expected short-term challenge and eventually become less reliant on public domestic support.

The large defence contractors also face much better long-term export opportunities than the SMEs. In fact, as recalled above, in an open market, it is large and competitive firms that are likely to reap the benefits of international trade activities, whereas smaller and less productive enterprises will find it more difficult to thrive in a more open and competitive market (Stone Sweet and Sandholtz 1997). This means that larger enterprises will in general be more willing to adjust to liberalization processes because of the expected benefits this will bring them in the longer term.

For both of these reasons – expectations of short-term challenges and longer-term opportunities – large defence companies will be more directly affected by market liberalization and hence more prone to rapidly adopt active strategies to cope with a changing policy regime. By contrast, SMEs do not expect to be directly affected by liberalization to the same extent as larger firms, because they typically rely much less on public domestic support, and also because they are much less frequently engaged in international activities. Hence, SMEs are less likely to adjust their business strategies substantially.

5. CASE STUDIES

The case studies are based on in-depth interviews with the top-level management of several large and small and medium sized companies in Norway and Sweden. The interviews were semi-structured, in the sense that an interview guide was developed to ensure that the same topics were addressed in Norway and Sweden, but the interviewees were allowed to talk rather freely about the issues (George and Bennett 2005). The interviews were carried out in the summer and fall of 2012. The sample consisted of a total of 11 large and small- and medium-sized companies in Norway and Sweden: in Norway, Kongsberg Defence and Aerospace, Nammo Raufoss and Thales Norway (large) and Chemring Noble and T&G Harnessing (SMEs); and in Sweden, Saab, Bofors and Hägglunds (large) and S&T, AAC and Syntell (SMEs). These 11 companies account for a very large share of the value-added, employment and export in the defence industries in Norway and Sweden.

5.1. The Norwegian case

5.1.1. *The pre-Directive policy regime*

The Norwegian defence contractors described the Norwegian defence industrial policy regime as crucial for their survival, but highlighted the importance of policy mechanisms that secured access to foreign markets – such as offsets, international cost/work share agreements and internationalization support. Two of the largest Norwegian defence contractors – Kongsberg and Nammo – described offset as a vital 'door-opener' to foreign markets. Kongsberg pointed out that most of its foreign customers want to see its defence equipment operated by both the Norwegian and one other foreign country's armed forces before they would consider purchasing the equipment, and explained that offset could therefore help to identify and link to an essential 'foreign reference customer' that it is vital to break into overseas markets. Kongsberg also mentioned that it increasingly meets offset demands in foreign markets (such as Canada, Brazil, India and South Korea) and needs national offset credit to 'swap' against such obligations. And both Kongsberg and Nammo clearly stated that several of their most important product lines had emerged as a result of past offset agreements. The large Norwegian defence contractors also highlighted other policy mechanisms that could secure access to foreign markets. All the three large defence contractors described international cost-share/work-share agreements as important for both product development and market access, and Kongsberg and Thales pointed out that they benefitted greatly from the help they have received from the government and armed forces in showcasing their defence systems abroad.

The large defence contractors were less dependent on more traditionally protectionist policy instruments, such as 'direct purchase without competition'. They described direct purchase as important for their business, but they also pointed out that these contracts came with profit regulation clauses[4] and that they seldom were very lucrative. On the other hand, one of the large defence companies, Thales Norway, pointed out that these contracts allowed it to engage in close collaboration with the Norwegian armed forces, provided them with an important 'national reference customer' and allowed them to develop new products that they could later sell to other countries. The two other large companies mentioned that direct purchases were only important for a few product lines and that they in general competed fairly openly for contracts on the Norwegian market, winning some and losing others. All the three large defence contractors, on the other hand, described research and development (R&D) contracts as very important for the development of new products. Kongsberg and Nammo mentioned several products that have been developed under contract with the Norwegian armed forces, such as the naval strike missiles (NSM) and the armour piercing, high explosive ammunition (APEX).

The small- and medium-sized defence companies were on average less dependent on the Norwegian defence industrial policy regime. One of the smaller companies, T&G, described offset as a source of larger contracts and a way

to secure important foreign 'reference customers'. But it pointed out that offset was more important to secure its role as sub-contractor to large Norwegian defence companies on foreign contracts, since the offset credit could be used to counter the expectations in foreign markets that the large Norwegian defence companies should use local sub-contractors.

5.1.2. *Consequences of the EU Directive*

The Norwegian defence contractors were in general positive to a possible liberalization of the European defence market, but none of them believed that the European market would actually become more open in the future. Quite the contrary, many believed that the European defence markets would become less transparent and more protectionist as a result of the EU Directive.

The reason for this pessimism was that the defence contractors doubted the sincerity of the largest EU members, the willingness of the EU to enforce the Directive and their own ability to assert their rights. Several defence companies expressed serious doubt that the UK, France and Germany had any real intention of opening their defence markets. Instead, they speculated that these countries had supported the Directive because it could help them 'get rid of the small countries' industrial bases, especially the Eastern European SMEs'. Several defence companies also stated that the financial crisis would make most countries hesitant to follow the Directive and the EU even less inclined to 'go after' the countries that violate the Directive. Finally, several of the large defence contractors pointed out that, in case of disagreement on the implementation of the Directive, they could not 'drag their international customers to court', since they have few customers and were dependent on maintaining a good relationship with them. Nevertheless, most of the defence companies believed that there would be few short-term changes. They mentioned that past offset obligations would still be valid and that most defence contracts were for long-term deliveries. But based on their pessimistic outlook on the Directive, the defence companies described several long-term scenarios that they envision might take place in the future:

- 'Offset under the table': many countries will continue to demand offsets on large national acquisitions – but state these demands informally as implicit expectations.
- 'Cost/work-share lock-out: the large European countries – the UK, France and Germany – will sign exclusive cost/work-share agreements to develop new defence equipment that they will sell to the smaller European countries. Since the small countries can no longer demand offsets, they will be 'forced' to purchase the equipment without being able to participate in its development or production.
- 'Split and combine': defence equipment can be divided into several 'levels' – from platforms to weapon systems to components – and the large European countries will use this possibility to strategically divide or combine their

acquisitions in a way that favour their domestic industries and protect them from foreign competition.
- 'Lock-out by specification': defence equipment can be specified according to a wide range of parameters, and the large European countries will use this possibility to specify their tenders in a way that favours their domestic industries and protect them from foreign competition.

Although the large defence companies expressed a lack of trust in the EU system, they conveyed much greater faith in the Norwegian government. They said that they were concerned that the Norwegian government would be more 'Catholic than the Pope' – i.e., that it will follow the Directive more strictly than other European nations, but they believed that the government would watch the developments in Europe carefully and take appropriate actions to secure the future viability of the Norwegian defence industry.

The small- and medium-sized defence companies varied in their view on how they would be affected by the Directive. One of them said that it was indirectly vulnerable to ill effect of the Directive because its business was tied to the large Norwegian defence contractors as a sub-contractor and that it would be adversely affected if they were. The other said that it would not be affected at all, since its export contracts were simply too small to be influenced by changes in defence industrial policies.

5.1.3. *Strategies to meet the new EU Directive*

Most of the defence contractors said that they would adopt a 'wait-and-see' strategy towards the Directive and would mitigate potential ill effects by raising the awareness about their market conditions among Norwegian policy-makers (lobbying). The Norwegian defence contractors gave several reasons for adopting this strategy. They pointed out that the impacts of the Directive was still fairly uncertain and that it would be premature to change their strategies before they knew how the European market would evolve. They also said that they had already exhausted most strategic responses to the Directive: they already focused on core competencies and collaborated to a large extent with domestic and foreign firms and R&D institutions. And few of the Norwegian defence companies believed in moving parts of their business off-shore, since security issues would make it difficult to move crucial technology abroad and vital inputs – such as highly skilled labour and electricity – were still fairly inexpensive in Norway.

Nevertheless, some of the Norwegian defence companies mentioned that they might reconsider their strategies in the future if the Directive would make it more difficult to do business in Europe. One of the large defence companies mentioned that they might focus more on the American market, and one of the small- and medium-sized companies mentioned that they might focus more on the civilian markets.

5.2. The Swedish case

5.2.1. *The pre-Directive policy regime*

The Swedish defence contractors described the Swedish defence industrial policy regime as having been very favourable, with a strong public support for R&D, high ambitions for domestic defence technology development and an unusually high percentage of the defence budget being used on materiel acquisitions. These conditions, however, started to change a few years after the end of the Cold War. From the early 1990s, there has been gradual decreases in defence budgets, defence R&D, indigenous defence development and defence materiel acquisition. In recent years, under the Conservative government that came to power in 2006, there has also been a clear trend towards market liberalization – with a focus on buying defence technology 'off-the-shelf' and ending the preferential treatment of Swedish defence suppliers. Consequently, the share of foreign suppliers in the Swedish market has increased substantially in the last five years.

Offset has not been a prioritized policy tool by Swedish governments, compared to the Norwegian case. The larger companies have exported many large defence systems and have had to fulfil offset obligations abroad. But they have only to a limited extent been supported by offset demands by the Swedish government for domestic production in Sweden (Axelson and Lundmark 2009). One of the SMEs interviewed has, however, benefitted greatly from offset obligations to Sweden over the years.

All Swedish firms interviewed regarded direct purchase and R&D support as having been highly important for their business, and even more so for the primes. The SMEs were discontent that too much of the R&D support was going to primes and that these larger domestic companies (in particular Saab) were able to control and decide upon how much (or little) of this funding would befall their smaller specialized suppliers. International support and government-to-government collaboration schemes were also seen as important. On the whole, however, there is no declared and explicit Swedish 'defence industrial policy', as in many other EU member states, and the Swedish defence companies regret the absence of such a strategy.

The Swedish defence companies overall underline that Sweden has for several years (at least since 2007) been bringing the national defence procurement system in line with the EU Directive. Their strong presence on the export market is, according to the companies, a result of the previous ambitions of building a strong Swedish defence industry. The firms see these strengths and advantages as slowly dwindling, since there is now very little government financing of new product development.

5.2.2. *Consequences of the EU Directive*

If all European nations would interpret the Directive fully, transparently and in the same manner, the Swedish companies would highly welcome the result: the effect would be the creation of a less protected, more transparent and more

competitive defence market with greater opportunities for everyone. The Swedish companies, however, foresee a more uneven implementation of the Directive. A popular metaphor used was to describe the Directive as a Swiss cheese, where every nation would try to find the (loop-)holes. In the short run, the companies expect a slow and cautious implementation, where EU members will watch each others' steps and will not be willing to fully open their own national markets. In any case, they foresee some new business opportunities, but also some possible threats.

The companies also expect a number of specific effects in the marketplace owing to the Directive: more acquisition-related legal appeals; increased bundling of defence contracts from procurement authorities; even fewer defence programmes; and further industrial consolidations. These trends can already be seen, but the firms expect these trends to reach a greater momentum owing to the Directive. All the companies also foresee less use of indirect and civil offset, which they welcome. Several of the companies, however, believe that offsets will still be demanded, but implicitly and perhaps under different labels.

The three SMEs were particularly positive to the Article 21 in the Directive, a non-mandatory item stating that nations *may* demand that up to 30 per cent of the defence contracts should be outsourced to other companies. They were, however, sceptical of its impact and wider implementation in the EU – and Sweden has in fact chosen not to transpose this article into Swedish law, which constitutes a great loss of business opportunities for these companies.

5.2.3. *Strategies to meet the new EU Directive*

All the Swedish companies regard themselves as being well prepared for the implementation of the Directive, since they have already grown accustomed to reduced government support and a more liberalized home market. They have been forced to export and internationalize and see this as a competitive advantage. However, the defence companies also expect to meet several challenges that stem from the possibly heterogeneous implementation of the Directive, among others that the largest EU members (France, Germany and the UK) will create bilateral or trilateral accords on defence procurement in order to circumvent the Directive and that the procurement processes will be marred by more appeals and other legal issues. The interviewed companies underline that a thorough understanding of the implications of the Directive is crucial. They foresee that their tenders must become much clearer and more focused in the future in order to better persuade their customers and to limit the risk of appeals, and that they need to increasingly engage in different forms of foreign collaboration in order to improve their business performance (e.g., networks or through EDA or Nordefco).

The interviews also point to some important differences between the large defence contractors and the SMEs. The largest and most important Swedish enterprise, Saab, said that it has enforced a strategic revision of all the divisions in the group regarding how the post-Directive conditions will affect its business environment. The other primes strive to continue in the same direction, and

foresee less and less dependence on Swedish defence procurement, increasing internationalization and a stronger dependence on the foreign owner's perception of their business opportunities and potential. By contrast, SMEs do not regard it as realistic that they will be acquired by foreign companies in the future, or that the foreign owner would move their activities abroad, since it would not be easy move their staff or transfer their competencies to a foreign location. The SMEs all underline that it will be even more important to have an internationally competitive and attractive niche capability, as competition will increase in Sweden and greater business opportunities will emerge abroad. SMEs state that they will have to expand their business opportunities through networks with other Swedish and foreign SMEs, since they will be too small to pursue foreign business opportunities alone. The SMEs overall do not believe that the Directive will affect their business environment more than marginally.

6. DISCUSSION

We will now summarize the main results of these case studies and discuss their relevance to illustrate the validity of the theoretical Hypotheses 1 and 2 that were outlined out in Section 4. First, looking at the country dimension (Hypothesis 1), our study finds that both the Swedish and the Norwegian defence contractors believe that the larger EU member states will only to a limited extent 'comply' with the new Directive and that they will use legal 'loopholes' in the Directive to engage in forms of 'economic patriotism' that favour their own industries at the expense of the industries in smaller European countries.

Nevertheless, the Norwegian defence companies are significantly more pessimistic than their Swedish counterparts are. They envision a range of scenarios where protectionist policies will be concealed rather than abolished and the large European countries will use the Directive to 'force their way' into the markets of the smaller European countries while still shielding their domestic defence industries from foreign competition. Nevertheless, they believe that the Norwegian government will mitigate some of the ill effects of the Directive by following the developments in Europe and taking appropriate steps to ensure that they can compete on a 'level playing-field'. However, they are also concerned that the Norwegian government will become so 'compliant' with the new Directive that the government finds no 'room' to look after their interests – a finding that echoes the common argument of Nordic exceptionalism in the EU compliance literature (Sverdrup 2004: 39). They have therefore adopted a 'wait-and-see' strategy where they will have a keen eye on the European developments and maintain a good dialogue with the government about how potential changes are affecting them.

The Swedish defence contractors have a somewhat more positive outlook on the Directive – believing that it will gradually and over time result in a somewhat a more open European defence market. Nevertheless, they foresee a mixed

and uneven implementation of the Directive, where the larger EU members might use cost-share/work-share agreement to 'circumvent' the Directive and safeguard national interests and some of the smaller EU members might still, implicitly and under different labels, demand offsets. They believe that this more liberalized market will provide them with some new business opportunities abroad, but may also deprive them of some existing business opportunities at home. But unlike the Norwegian defence contractors, they do not expect any help from their government. The Swedish defence contractors have therefore begun to implement a range of strategies to improve their chances on the export market, e.g., by setting up clearer and more focused tenders, and by increasing their participation in international collaborations with other European firms.

In sum, these two contrasting cases illustrate the empirical relevance of the first hypothesis that we pointed out in Section 4. In Norway, where the level of protection is higher, the defence companies are in general more sceptical and less inclined to support ongoing liberalization processes than the defence contractors in Sweden, which have for some time grown accustomed to compete in a more open and less protected economic environment.

Shifting the focus to the second hypothesis, we find that the SMEs depend in general less on their domestic defence industrial policy regimes than the large defence contractors and are in this sense less likely to be adversely affected by the new EU Directive, at least in the short run. While large defence contractors have historically been very reliant on domestic policy support measures, both the Norwegian and Swedish SMEs we have met state that most national policy instruments are either not important or only somewhat important for their business. Some of the SMEs also point out that they are less at threat by possible trade barriers that the larger EU members might try to erect to circumvent the Directive than the large defence contractors. Unlike their larger counterparts, they consider themselves to be too small and too specialized for any country to 'feel the need' to develop specific countermeasures to protect their domestic businesses against them. In this sense the SMEs can be seen as less dependent on public protection and support than the larger defence contractors – and hence less exposed to the short-run changes of national policy regimes that will be brought on by the new Directive. However, in the longer term, the SMEs can also be vulnerable to the effects of the new EU Directive, because they depend on the large companies as sub-contractors and have fewer resources to deal with legal wrangling.

Overall, the two cases confirm the second hypothesis, that large defence companies are more willing and more rapid to adjust to liberalization processes than SMEs, because of the greater challenges they face in the short-run and the higher opportunities they foresee in the longer term.

For EU authorities, it is important to note that many of the companies we interviewed were quite sceptical with respect to the actual implementation of the Directive and feared that, if this policy change is not carried out in an even and balanced way across countries, it might end up favouring the larger

nations (i.e., Germany, the UK and France) *vis-à-vis* the smaller countries (e.g., Norway and Sweden). Put differently, if the timing and process of implementation will differ substantially across countries, firms in the smaller markets will in general be more sceptical and less responsive to the liberalization policy. Hence, the Directive will only work and have the anticipated positive impacts on the European defence market if it is effectively implemented in all European countries in a balanced and co-ordinated manner. Co-ordination and harmonization of this process will be crucial for achieving a positive outcome.

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NOTES

1 The EU member states were to transpose (bring into national legislation) the Directive 2009/81/EC by 21 August 2011. By July 2012, four member states had still not transposed the Directive, but by April 2013 all member states had transposed it (http://export.gov/europeanunion/defenseprocurement/) (Accessed 10 November 2013). Meanwhile, Norway – an EFTA member state – had by that time yet to transpose the Directive.

2 The Directive does not specifically mention offsets, since the Commission has previously declared it unlawful, and it cannot regulate illegal practices. Nevertheless, in 2009 the EC Directorate General Internal Markets and Services issued a guidance note concerning the use of offsets.

3 A cost-share/work-share agreement is an agreement where all partner nations in a collaborative armaments development project receive work tasks that directly correspond to their share of the total cost. This principle is the dominating setup for multilateral arms collaboration.

4 These clauses set caps on profit margins and also permit the procurement agency certain defined access to the companies' production plans.

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