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# EUROPEAN DEFENCE FIRMS: THE INFORMATION BARRIER ON PRIVATE FINANCE\*

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## Abstract

After the fall of the Berlin Wall, European governments adopted a hands-off policy towards the defence industrial base, in an attempt to increase the sector's efficiency and reactivity. In this context, one topical issue is how to motivate defence firms to apply for private rather than public finance. Since banks have no prior experience with European defence firms, a problem of asymmetric information may block this transition. The problem is analysed within the framework of a game between defence firms and banks. It is shown that the Bayesian Equilibrium might correspond to a situation where low-risk firms prefer the state-financed scheme; yet, in a perfect information set-up, the same firms would apply for bank credit. In order to facilitate the transition to private finance, the government might decide to subsidize investors who agree on financing

defence firms; the state aid should be made available during a transitory learning period.

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Keywords:

European defence firms

Private finance

Bayesian Equilibrium

Asymmetric information

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## Notes

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<sup>1</sup>See, on these changes of the EU defence sector landscape, Deitrick ([1999](#)), Guyot and Vranceanu ([2001](#)), Hartley ([2003](#)), Hartley and Sandler ([2003](#)), Kollias et al. ([2004](#)), The Economist ([2005](#)).

<sup>2</sup>The average leverage ratio of US defence firms is about 35% (Goyal et al., [2002](#)).

<sup>3</sup>See also the survey by Jaffe and Stiglitz ([1990](#)).

<sup>4</sup>For instance, see the surveys by Rogerson ([1994](#), [1995](#)). Either the firm or the government may defect on the initial terms of the contract. The higher the market

power of one of the contracting parties, the higher the probability to aim at renegotiating the contract or shirking.

<sup>5</sup>Adding a second risk, related to external uncertainty stemming from the randomness of the government's commitment, would not change in a significant way the main insights of the model.

<sup>6</sup>Actually, firms hold several overlapping projects and the class of risk is a weighted average of the risks specific to each project. Assuming that the firm may be represented by one project is tantamount to considering a firm running identical-risk projects.

<sup>7</sup>These operating costs come due at the end of the period. The total production cost is  $K(1 + r) + \dots$  under private finance or  $K(1 + i) + \dots$  under public finance.

<sup>8</sup>Under a fixed price contract, many governments used to finance a fraction of the debt at a low interest rate. We do not introduce here a linear combination of private and public funding since this generalization would not alter the main insights of the model.

<sup>9</sup>Since  $\dots$  and  $F(1) = 1$ , the branch of  $F$  located to the right of the asymptote is outside the domain of existence of  $\pi^L$ .

<sup>10</sup>If  $\pi_1$  were smaller than  $\pi_4$ , the two regions would not overlap and this separating equilibrium would not have been possible. We also mention that  $\pi_1$  can be smaller or bigger than  $\pi_3$ .

<sup>11</sup>A pooling equilibrium where all firms would choose the private finance can be put forward for relatively low default risks  $\pi^L$  and  $\pi^H$ .

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