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Time to spend smart

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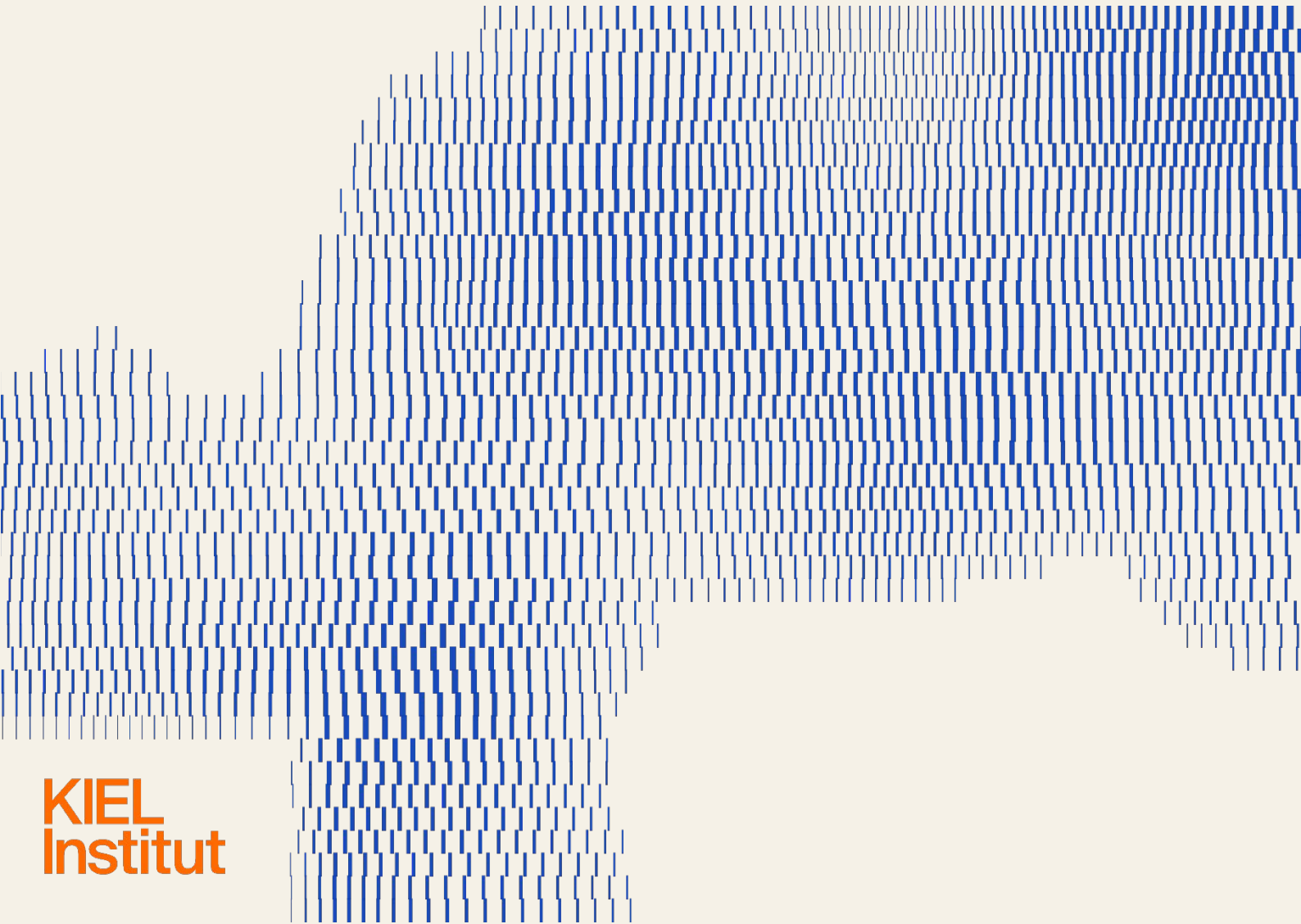

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Overview

- Europe is the world's second largest defence spender after the U.S., ahead of China. Yet despite substantial financial inputs, Europe has a fraction of the military capabilities of others. So far, it has also failed to update its rearmament strategy to include new defence technologies and associated mass production of low cost autonomous systems.
- At the root of European military weakness lies a blatant inefficiency: Europe fields 14 different main battle tank models to America's one, 23 howitzer variants to America's two, 16 submarine types to 4 in the U.S. The fragmentation of European defence planning and procurement along national lines, and the artisanal nature of national defence production condemns Europe to low volumes, high unit costs, limited interchangeability, and technological backwardness.
- The imperative to focus on outputs, not inputs, is nowhere more consequential than in Germany, where defence spending is set to triple over the coming years. Germany should pursue a defence strategy in line with its comparative advantage – mobilising its capital base (i.e., German industry) to allow for the rapid scaling-up of military capabilities, including the expansion of production capacities to sustain a longer conflict. At the same time, Germany must invest massively in upgrading its technological potential to pursue a technology and automation-driven defence strategy.
- Taking this yardstick to the publicly available German budget numbers as well as future appropriations passed by the Bundestag leads to a sobering conclusion. Germany so far has neither invested heavily in next generation defence capabilities, nor has it used capital (its industrial base) to substantially increase defence output. Nearly all of the Bundeswehr's €100 billion Special Fund – around 95% – has been committed to traditional crewed platforms while production capacity increases have been slow and small. At the same time, the share of the defence budget allocated to R&D stagnates at around 2% – less than 1/5 of the U.S. share, limiting technological renewal.
- We set out five principles for smart German spending on defence: (i) prioritise the procurement of innovation and raise R&D expenditure to at least 10% of the defence budget; (ii) focus on increased production capabilities and industrial scale through capacity contracts rather than classic procurement; (iii) expand support for Ukraine in the short-run as the cheapest and most effective way for security in Europe in the short-run; (iv) centralise procurement and create a common European defence equipment market; (v) establish joint financing, including Eurobonds, for joint ownership of next generation defence technologies as a first step toward integrated European defence.

Keywords Defence spending; NATO burden sharing; Military capability; Defence industrial policy;European integration

JEL classification H56, H57, H41, O38, F5

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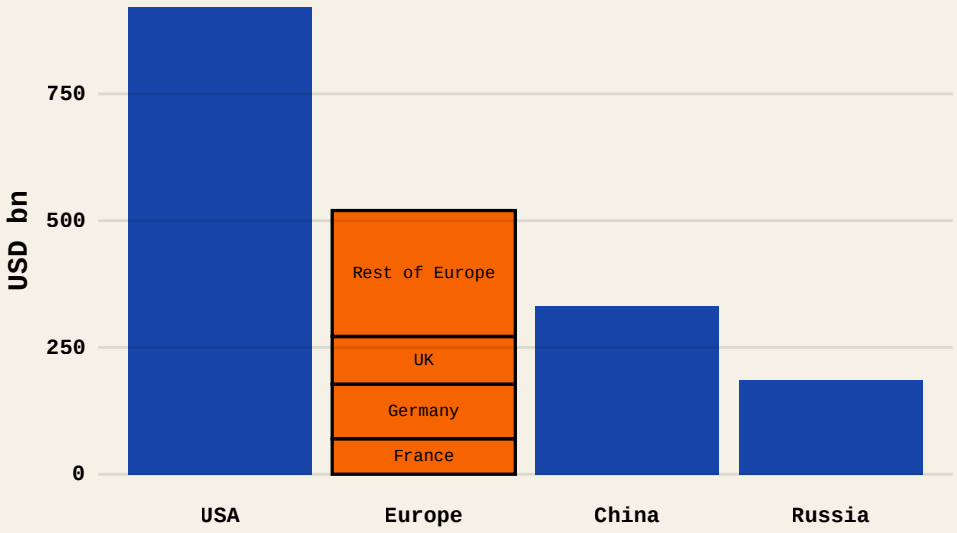
1 What does Europe get for its money?

The European defence debate has centered on insufficient resources dedicated to the continent's defence. It's time to move on. Defence budgets have risen substantially in 2025 and are on track to rise further in 2026 and 2027, chiefly driven by a pronounced increase in German defence outlays. According to new IISS data, European defence spending now stands at approximately USD 550 billion, making it the second largest in the world (see Figure 1). Europe's cumulative spending exceeds China's defence budget by about 150–200 billion per year (at market exchange rates) and is about three times higher than Russia's. By the same token, Europe's military support for Ukraine also looks much less impressive when scaled by the region's total defence spending. Last year Europe's military support for Ukraine added up to 40 billion, only about 6% of total European defence spending.

Figure 1: Europe is the second largest defence spender in the world but has a fraction of the capabilities



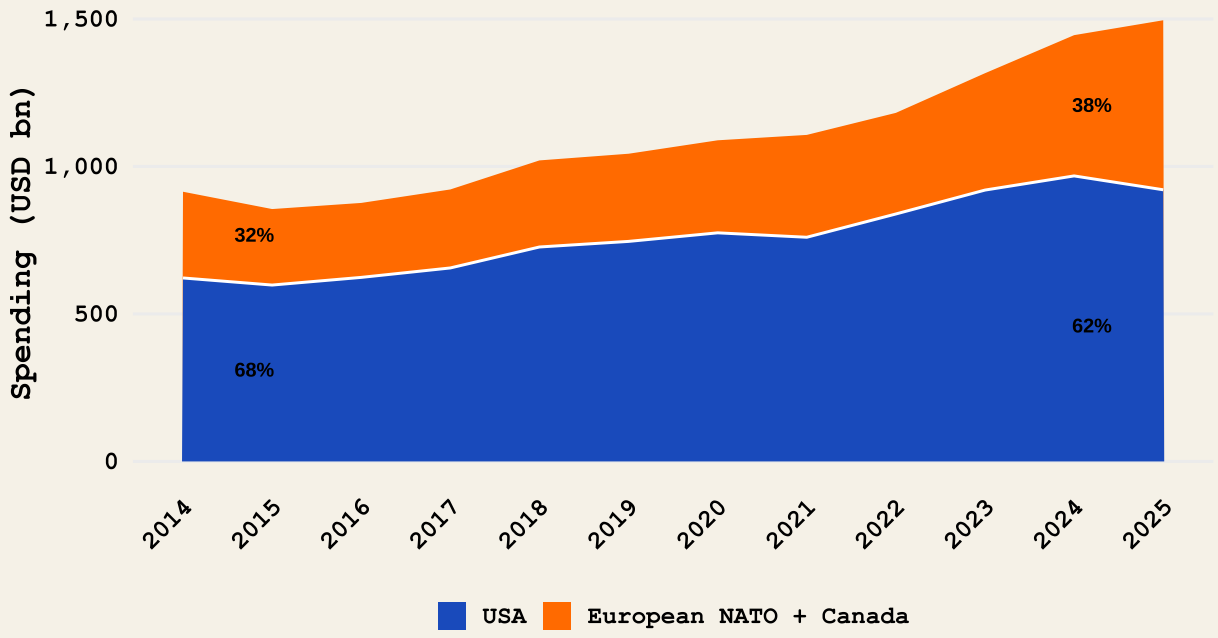
Source: "The Military Balance 2026" International Institute for Strategic Studies (2026); at current prices.
Note: We assume that the actual Chinese defense spending is 1/3 above the official defence budget.

Yet despite being the world's second largest defence spender, the continent punches well below its strategic weight. Europe to this day has large and critical gaps in its military ca-

pabilities in space and rocket systems, communications infrastructure, not to mention military cloud, software and AI capabilities. Without serious reform, these efficiency losses arising from the fragmentation of European defence spending risk growing further.

The military spending numbers also offer a new perspective on the burden sharing debate between Europe and the U.S. In 2025, European defence budgets already accounted for about 60% of total U.S. spending (USD 920 billion) on defence in 2025, as shown in Figure 2. Europe's financial contribution to NATO defence is already substantial. Europe's capability gap is not financial, but real. Europe has to move on from discussing inputs (money) to increasing outputs (military capabilities). In short, Europe has to focus on maximising military output per euro spent.

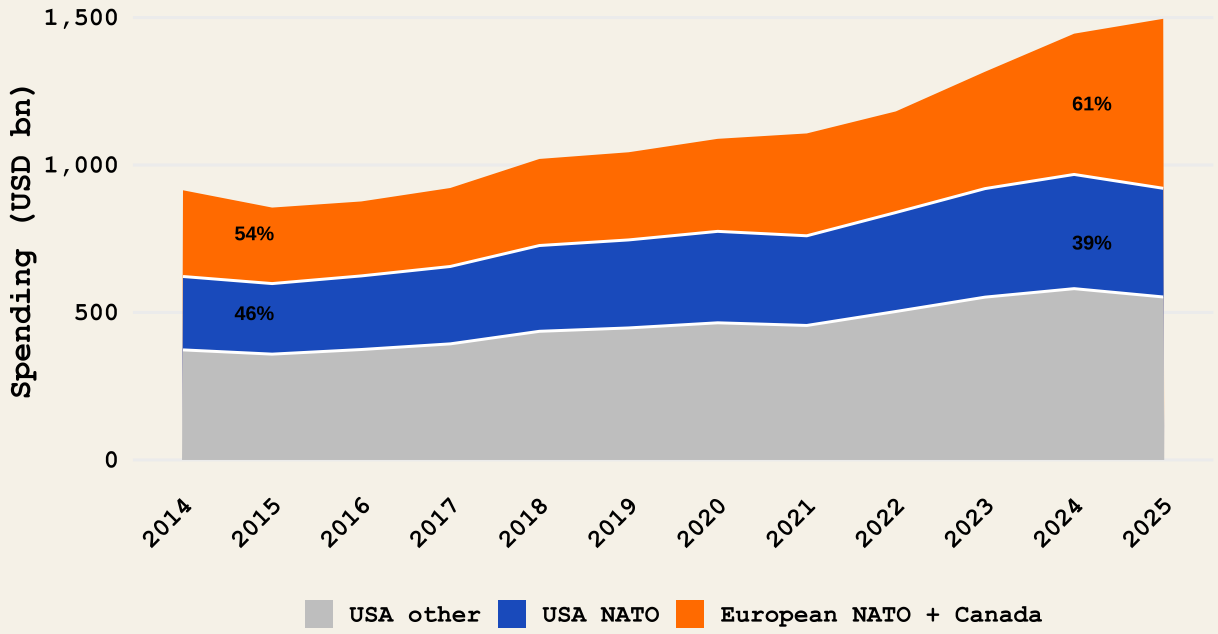
Figure 2: Europe and Canada accounted for close to 40% of total NATO military spending in 2025



Source: "The Military Balance 2026" International Institute for Strategic Studies (2026); at current prices; sample includes NATO members at the respective time; author's calculations.

Moreover, a large share of U.S. defence spending is devoted to non-NATO commitments. One study put the share of U.S. defence resources dedicated directly to European defence at only 15% (Deloitte, 2019). But even if one adds on global capabilities and assumes that the share of non-Nato defence in Asia-Pacific, the Middle-East and other regions account for about 60% of U.S. defence spending, Europe already outspends the U.S. for NATO defence both in absolute terms and relative to GDP (see Figure 3).

Figure 3: Europe outspends the U.S. on NATO defence



Source: "The Military Balance 2026" International Institute for Strategic Studies (2026); at current prices; sample includes NATO members at the respective time; author's calculations;
Note: The figure assumes that approximately 60% of U.S. defence spending is allocated to non-NATO commitments (Asia-Pacific, Middle East and other regions).

However, despite these large inputs, European defence capabilities remain a fraction of the U.S., mainly because of the fragmentation of European armed forces. Table 1 puts numbers on this fragmentation problem. Europe fields 14 different main battle tank models to America's one, 23 howitzer variants to America's two, 16 submarine types to 4 in the U.S. The fragmentation of European defence planning and procurement along national lines, the artisanal nature of national defence production and the lobbying power of national champions condemns Europe to low volumes, high unit costs, limited interchangeability, and increasingly also technological backwardness.

Table 1: European defence fragmentation

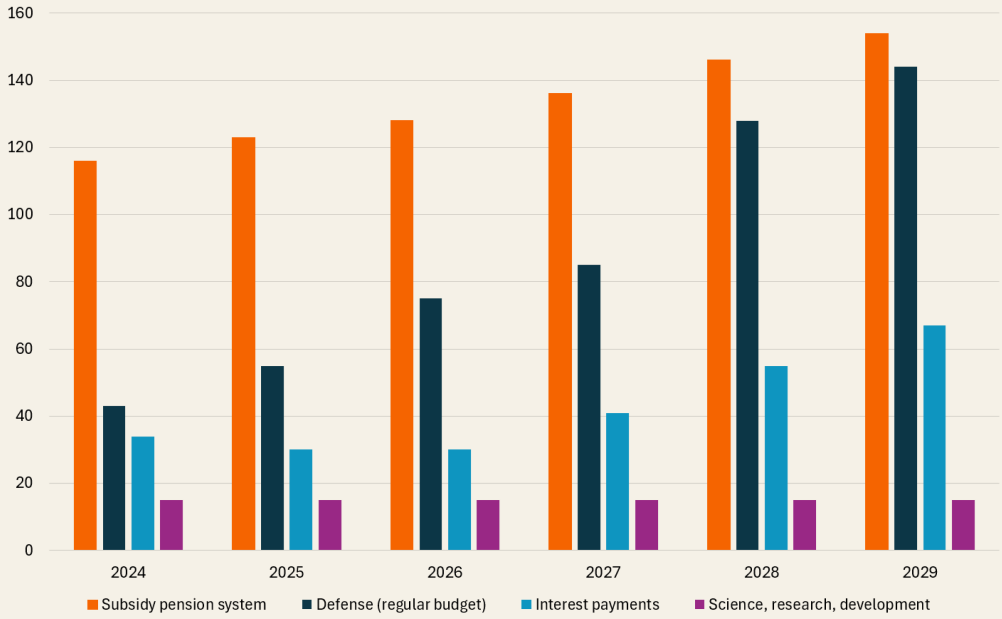
Weapons System	United States	Europe
Main battle tanks	1	14
152/155mm howitzers	2	23
Torpedoes	3	24
Armored infantry fighting vehicles	3	21
Submarines	4	16
Anti-ship missiles	3	8
Long-range air defence systems	4	8
Air-to-air missiles	5	15
Attack helicopters	2	5
Tactical combat aircraft	9	15

Source: Chinn et al. (2026)

2 Breaking down German defence spending

The imperative to focus on outputs, not inputs, is nowhere more consequential than in Germany, where defence spending is set to triple over the coming years. Figure 4 shows the dramatic surge in Germany's planned defence outlays. The key question for German policy makers is: How can Germany, as the main economy in Europe and the continent's industrial backbone, make the best use of the substantial new funds going into defence?

Figure 4: Surging defence spending in Germany



Source: Finanzplanung des Bundes, (Bundesministerium der Finanzen, 2025)

From an economic perspective, the starting point is that Germany is endowed with plentiful capital and substantial technological capabilities, but does not have lots of people to fill the armed forces. Moreover, protection of human life is a central objective for society. The upshot is that Europe should pursue a defence strategy that builds on its comparative advantages, i.e., a strategy that uses the inputs that are plentiful – capital and technology – and saves as much as possible on the inputs that are scarce: people.

From this perspective, it is clear that Germany and Europe should pursue a technology and automation driven defence strategy and invest heavily in the build-up of technologies and systems that allow to defend the continent with minimal human inputs. Note that is not dissimilar from what Ukraine is doing already: substituting autonomous systems for soldiers and heavily investing in technological innovation to stay ahead of the adversary.

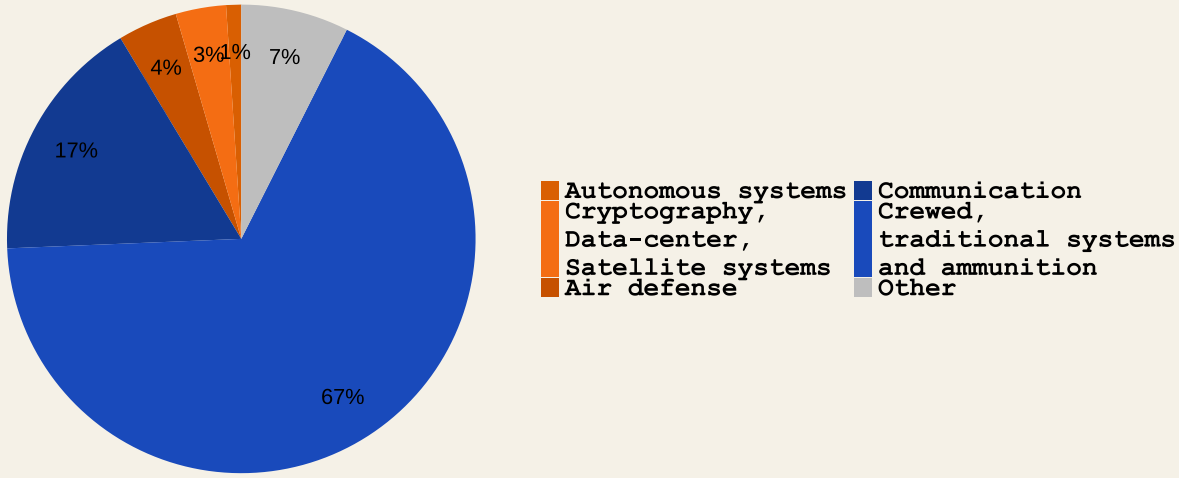
Germany (and Europe) should pursue a defence strategy that combines mobilizing its capital (i.e., its industrial base) to allow for the rapid build-up of military capabilities, including the expansion of production capacities to sustain a longer conflict; and invest massively in the upgrade of Europe's technological potential.

Taking this yardstick to the data of German defence procurement leads to a sobering conclusion, however. Our analysis relies on the available German budget numbers as well as future appropriations passed by the Bundestag. Until now, German defence procurement has done pretty much the opposite of what a strategy in line with our comparative advantage would suggest. Germany so far has neither invested heavily in next generation defence capabilities, nor has it used capital (its industrial base) to substantially increase defence output.

2.1 Heavy metal vs. the technological frontier

Figure 5 breaks down Germany's defence procurement from the EUR 100 billion special fund that was legislated under the former Chancellor Scholz after the 2022 Russian invasion. 95% of Bundeswehr spending from the Special Fund went to uses other than autonomous systems, data centers, and satellite systems. Instead, close to 90% of the money finances traditional crewed systems (such as tanks and aircraft) and associated ammunition and communication systems. The rest went to air defence and other uses, only a tiny fraction of 4% finances autonomous systems, data centers, or satellites.

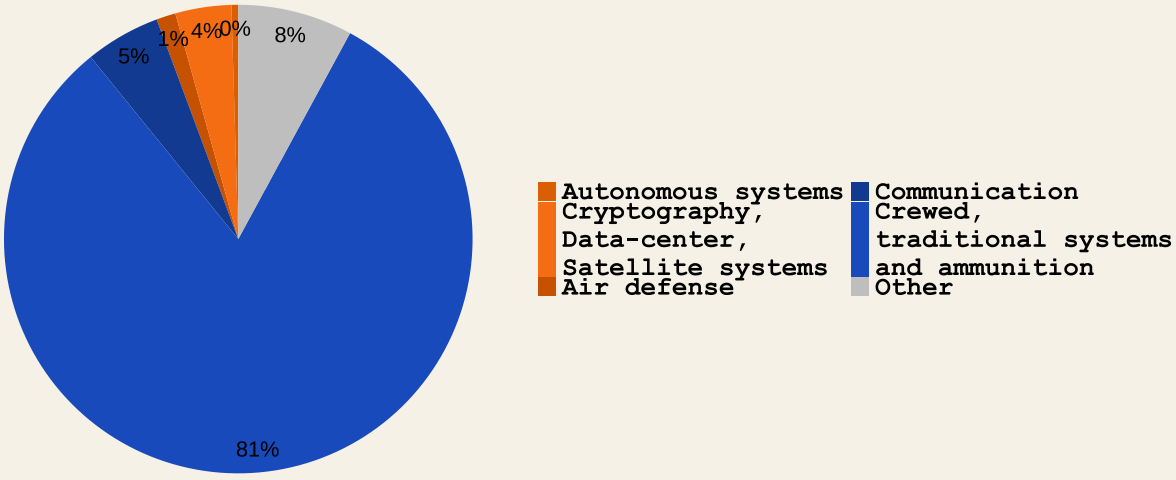
Figure 5: Composition of Bundeswehr Special Fund Spending



Based on the German Federal Budget, years 2022 to 2026, only Bundeswehr Special Fund, including future commitment appropriations. Global expenditure cuts not included. Classification based on chapter, appropriation item and designated purpose in the federal government budget. "Other" includes routine administrative expenses, non-military specific goods (e.g. furniture, food).

Figure 6 turns to forward-looking appropriations for future defence spending that have been agreed by the Bundestag. The data paint very much the same picture. At more than 80% of future spending is earmarked for legacy systems, the share of autonomous systems remains stuck at 1%. Even including air defence systems in the bucket of next generation defence technology does not boost the share of planned spending in the "defence tech" category beyond 5%.

Figure 6: German defence spending plans

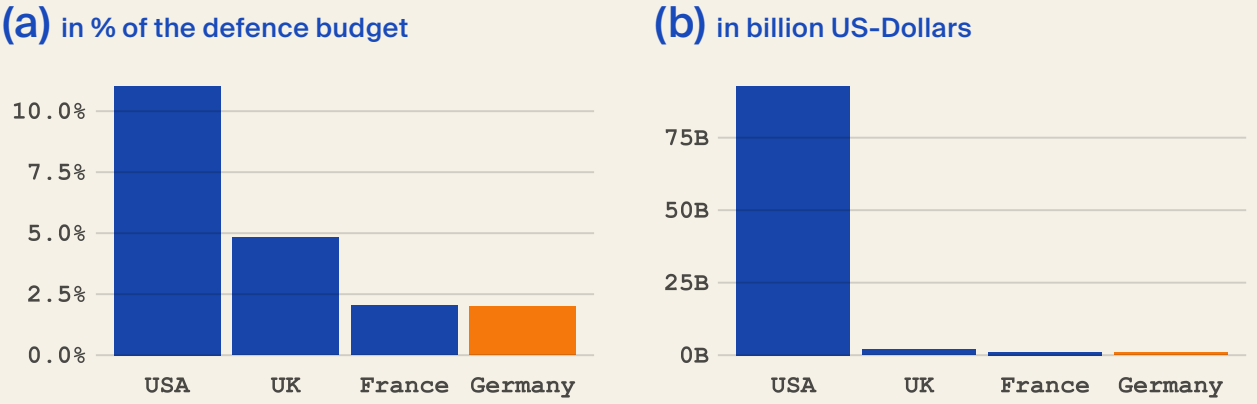


Based on the German Federal Budget 2026 for the defence department (EP 14) and including future commitment appropriations. Global expenditure cuts not included. Classification based on chapter, appropriation item and designated purpose in the federal government budget. "Other" includes routine administrative expenses, non-military specific goods (e.g. furniture, food).

Such a spending breakdown raises questions. Most research agrees that the lasting economic benefits of higher defence spending come from technological innovation and civilian spill-overs (Antolin-Diaz and Surico, 2025). The experience from the Ukrainian battlefield also points to the vulnerability of traditional armoured systems to drone attacks and a high share of damage inflicted by autonomous systems. Against this background, past and future spending shares around 95% for, broadly speaking, crewed systems look particularly high.

Moving beyond procurement shares to overall budget allocations for research and development, the same lack of vision is confirmed. The share of spending devoted to research and development stagnates. At only about 2% of total defence spending, Germany's research and development spending share is roughly one fifth of the U.S. share. The difference becomes even starker in absolute terms. U.S. military R&D spending of about USD 100 billion per year contrasts with a couple of billion on the German side (see Figure 7). Note that with an R&D share of 10% – still somewhat lower than in the U.S. – the R&D budget of the Bundeswehr would be in the EUR 10–15 billion range. This would be close to double the entire annual federal funding for Germany's major research organisations and could massively boost the country's technological potential.

Figure 7: Defence R&D-spending



2024 Data. Germany: Share of expenditure on defence research, development, and testing of materiel in the defence budget (Einzelplan 14). U.S. figures exclude RDT&E Management/Support and Operational Systems Development.; Sources: https://www.bundestag.de/presse/hib/kurzmeldungen-963378 https://www.defense.gouv.fr/chiffres-cles-defense-2024 https://www.gov.uk/government/statistics/defence-departmental-resources-2024/mod-departmental-resources-2024 https://www.congress.gov/crs-product/R47564 https://www.armed-services.senate.gov/imo/media/doc/fy24_ndaa_conference_executive_summary1.pdf, own calculations

2.2 Capital intensity: the race for mass

There is no question that other than focusing on innovation Europe also needs to increase output of existing systems fast. This relates to air defence systems, ammunition, and other systems. This is essentially a task of mobilising Europe's industrial base for mass production, i.e. employing capital for the defence effort. Note that Europe's GDP is ten times larger than Russia's and on par with China's. European industrial production is about five times greater than Russia's, and even European steel and heavy industry is two to three times larger. Europe has the capital to mobilise for the defence effort.

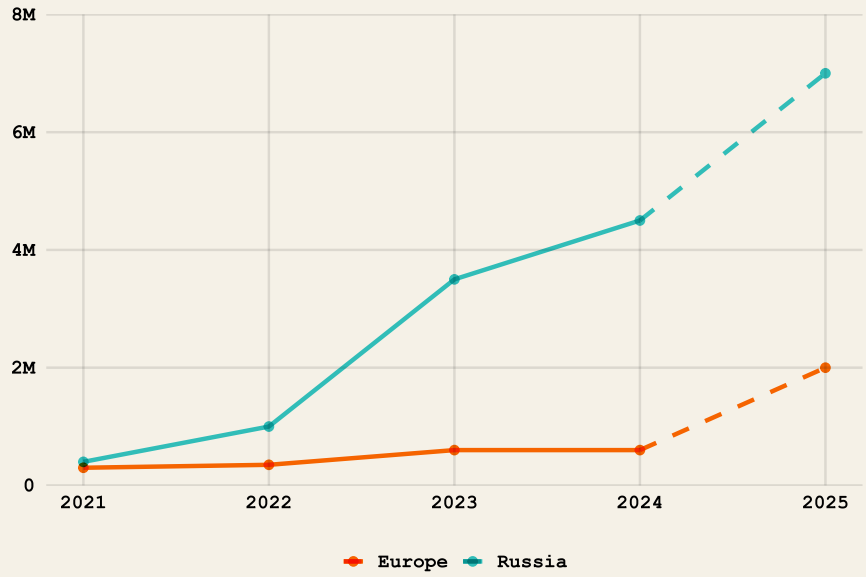
The current situation can be characterized as follows: (i) long production lead times, (ii) great uncertainty about future needs given rapidly changing security policy developments in Europe and the United States, and (iii) high unit costs due to artisanal production in small quantities with inadequate industrial scaling. Limited capacities, high unit costs, and long delivery times also mean that the mobilization of large financial resources for defence has generated only modest economic stimulus, since this too depends critically on additional investments to expand production.

While Germany has made only very modest progress in expanding production capacities in the defence industry, the growth in the Russian defence industry has been substantial. Germany and Europe are losing the race for mass (Burilkov et al., 2025) as production capacity relative to Russian production capacity has fallen behind further. Three examples across the defence space illustrate the inability to mobilize a far greater industrial potential – despite massive job losses across the sector – for defence. The examples taken here are ammunition, air defence, and space capabilities.

First, European production of 155 mm artillery shells has increased substantially since 2022. But volumes remain inadequate for sustained high-intensity warfare. Despite Eu-

rope's far larger defence spending, Russia currently produces roughly four times as many artillery shells annually, reflecting faster mobilization of capacity and fewer coordination constraints. This highlights Europe's persistent difficulties in scaling even low-complexity defence production (see Figure 8).

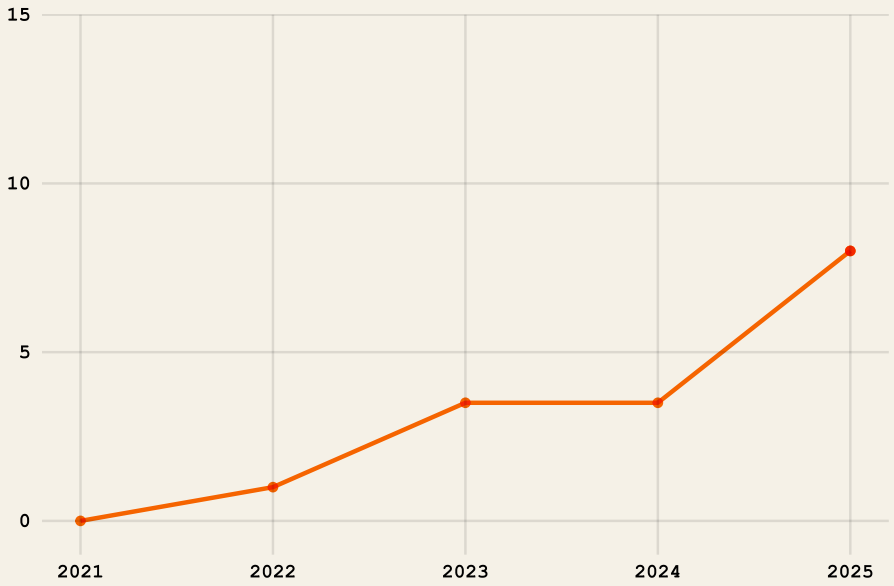
Figure 8: Russia is winning the race for mass production



Source: Estonian Foreign Intelligence Service, "International Security and Estonia 2024" (2024), Media reports (https://www.rferl.org/a/ukraine-weapons-shells-european-union-eu-war-russia-investigation/33025300.html, https://atlasinstitute.org/the-strategic-ammunition-gap-natos-industrial-lag-risks-deterrence/).

Second, production of essential air defence systems. Production of IRIS-T SLM systems has increases substantially in the last few years, but remains stuck in single digit numbers per year (see Figure 9). Similar modest increases can be observed in tank and vehicle production. Germany remains far from mobilizing its industrial base for defence. Note that Ukraine announced in February that it was able to produce 200 of its home-developed Flamingo FP-5 cruise missiles. It's priced at roughly under 1 million USD per unit, making it dramatically cheaper than Western equivalents. Flamingo production is a textbook example of exactly the kind of low-cost, mass-producible cruise missile the capacity contracts Europe needs the industrial base to build.

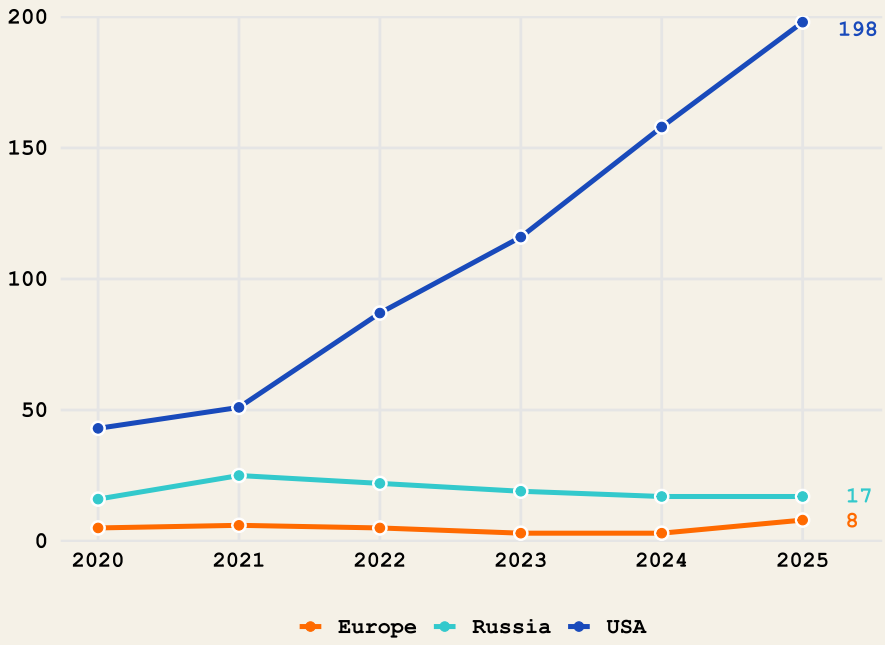
Figure 9: Annual production of IRIS-T SLM systems



Source: Media reports (https://norskluftvern.com/2025/12/11/iris-t-slm-emerges-as-europes-fastest-growing-air-defense-system/, https://www.reuters.com/markets/europe/german-arms-maker-diehl-ramp-up-production-iris-t-air-defence-system-2023-09-05/, https://www.reuters.com/business/aerospace-defense/diehl-boost-production-iris-t-air-defence-used-ukraine-ceo-says-2026-01-22/).

Other than in traditional defence systems, failure to achieve meaningful outputs for sizeable inputs is also obvious in the new defence technologies. Europe faces significant technological and capability gaps in space, advanced software, and AI. For instance, orbital launch capacity is critical to establishing communications, intelligence, navigation, missile warning, and targeting systems. In 2025, Europe managed only eight space launches, compared to almost 200 in the U.S. (see Figure 10). Since 2020, European orbital launches have not increased meaningfully. Over the same period, Russia has conducted roughly four times as many launches, while the United States has continued to increase launch cadence at a rapid pace.

Figure 10: Stuck in the doldrums – European orbital launches



Source: Media reports (https://space.skyrocket.de/doc_chr/lau2025.htm).

Taken together, these three examples – ammunition, air defence, and space – paint a consistent picture: Europe is failing to convert its vast industrial potential into military output. The following section sets out five principles for how Germany, and Europe, can do better.

3 Five principles to spend smart

1. **Procure innovation and raise the R&D spending share.** The procurement of innovation should be placed at the centre of Europe's defence strategy. Evidence from U.S. programmes shows that autonomous, flexible agencies with highly skilled programme managers, bottom-up project selection, and active project management outperform rigid, top-down systems. A combination of funding pushes for R&D and pull incentives through purchase commitments is most effective. For details, see the recent Kiel Report (Carril, 2026). A higher R&D share also delivers broader economic benefits: defence R&D generates civilian spillovers that crowd in private investment and raise productivity across the economy. Germany should set a target of at least 10% of the defence budget for R&D – still below the U.S. share, but a fivefold increase from today's level. At that share, the Bundeswehr's R&D budget would amount to EUR 10–15 billion annually, close to double the entire federal funding for Germany's major public research organisations.

2. **Scale production through smart contract design.** Europe must prepare for demand surges during a conflict and secure actual production capacity through contracts across the supply chain. Future scalability of production, unit-cost reduction, and ensuring secure supply chains and critical inputs must be central to the strategy.

   Classic procurement contracts – ordering specific quantities at fixed prices – are economically not a suitable mechanism for rapidly expanding production capacities. They offer no incentives for companies operating under uncertainty about future demand to invest in additional facilities. From a private-sector perspective, there are few incentives to invest today in production capacities that will only be fully utilised in the future if the security situation remains tense or an open conflict breaks out. From a political and societal perspective, however, there is an overriding interest in building and maintaining these capacities today, because this (i) has a deterrent and thus peace-preserving effect, and (ii) can avoid potentially costly and time-consuming production ramp-ups (including the necessary supply chains) in a real crisis, and (iii) capacity planning helps realizing economies of scale.

   Capacity contracts – in which production capacities for specific systems are tendered rather than quantities – are a viable alternative. Instead of paying for delivered units, the government finances the establishment and maintenance of production capacities that can be rapidly scaled up when needed. In other domains – such as vaccine production – a similar mechanism is already in use. As a contract design, this model is optimal for rapidly increasing production under uncertain future demand while simultaneously realising economies of scale. Which capacities are needed and in which areas (e.g., air defence, drones, tanks) would need to be determined on the basis of military planning. A capacity contract comprises two elements:

   1. *Capacity build-up.* The state compensates the manufacturer for establishing and maintaining a defined production capacity – including the supply chains for materials, equipment, and personnel – required to initiate or increase production at short notice. Payment is made regardless of whether production actually takes place. Example: the government contracts capacity to produce 1,000 air defence missiles per year.
   2. *Production offtake.* Buyer and producer agree on price and delivery conditions for future deliveries from this capacity. The buyer retains the right to exercise this option and order under the agreed conditions, but is not obligated to do so. Example: the state orders 200 air defence missiles per year from a total contracted capacity of 1,000, with the remainder held in reserve or available for export.

   For the government, several key advantages arise. In the short term, targeted and binding investment is made in additional capacities; once the capacity is in place, production can proceed at industrial scale with lower unit costs. In a crisis, procurement can proceed quickly and at pre-agreed prices. Secured industrial capacity also has a

deterrent effect, as it credibly demonstrates that rapid follow-on production is possible in an emergency. Capacity contracts directly lead to additional investments that generate economic stimulus. For companies, capacity contracts offer the decisive advantage that investments in additional production capacities no longer represent their own economic risk, since the mere provision of capacity is reliably compensated.

3. **Expand support for Ukraine and build joint industrial capacity.** Ukraine is today the most cost-effective contributor to European security. Operating under existential pressure, it has developed a lean, innovative defence industrial model – rapidly producing and iterating on autonomous systems, cheap cruise missiles, and electronic warfare capabilities – with very short development-to-deployment cycles. European security per Euro spent is highest when that Euro goes to Ukraine. Yet despite Europe's large and rising defence budgets, military support for Ukraine currently amounts to only the equivalent of 5–6% of European defence expenditures. This share should be substantially raised. Beyond transfers, Europe should pursue deeper defence industrial integration with Ukraine – co-production arrangements, joint R&D, and technology -sharing agreements that allow European producers to learn from battlefield experience while supporting Ukraine's long-term capacity to defend itself.

4. **Consolidate European procurement and build a common defence market.** On a European level, the case for cooperation and integration of defence procurement is strong. A single European defence procurement market could yield large cost savings, enhance interchangeability, and improve the coordination of surge-capacity investments. The fragmentation documented above – 14 different battle tank models, 23 different howitzers, 24 different torpedoes – is not just an accounting curiosity; it is the structural root cause of Europe's inability to achieve scale. Centralising procurement and harmonising production of existing weapon systems – including artillery, cruise missiles, air defence systems, manned aircraft, and airlift capacity – would directly address this. The diagnostics of the Draghi report apply here: lack of scale means higher unit costs and less defence capability per Euro spent.

   Creating a common European defence equipment market would serve two complementary purposes: increasing competition among existing major defence players, and encouraging new entry by expanding the scale of the potential market. European countries should open national procurement to one another. Joint procurement agencies should use long-term volume commitments – including through the capacity contracts described above – to extract lower unit costs and fund production ramp-ups. The goal is not merely to buy European, but to buy European *efficiently*.

5. **Joint financing of next generation defence technology.** Many defence capabilities that Europe currently lacks – such as satellite constellations, long-range missiles, strategic airlift, military cloud and AI infrastructure – have a distinct European public good dimension and cannot be efficiently provided at the national level. Joint financing of public goods is economically sensible. Joint debt issuance also makes sense, provided

joint liabilities exclusively finance joint assets as the bedrock of a common European defence.

There are three core reasons why Germany should be open to Eurobonds for defence: first, frontloading for deterrence is economically rational: the security benefits of credible capacity accrue immediately, while the costs can be spread over time. Second, the distribution of fiscal space in Europe is very unequal; without joint instruments, many member states face an inefficient guns-versus-butter trade-off that will delay rearmament and weaken deterrence. Third, joint liabilities would strengthen European safe asset supply and foster European financial autonomy.

A recent proposal by Hildebrand, Rey, and Schularick (2026) outlines a European Future of Defence Architecture focusing on next generation military technologies and strategic enablers (such as AI, cyber, and satellites) for a European coalition of the willing ("Team Europe"). A European Future of Defence facility would issue 1% of GDP in bonds with 10-year maturity each year for 10 years, and roll over the new debt so there are no payments (on principal or interest) for the first 10 years. With a GDP of 15.9 trillion in 2024 (a grouping comprising France, Germany, Italy, Spain, the Netherlands, Belgium, Luxembourg, Poland, Ireland, Sweden, Denmark, Finland, Greece, Estonia, Lithuania, and Latvia) and nominal growth of about 2%, cumulative spending would be about 1.8 trillion over 10 years (2026–2035) for the catch-up phase. This defence spending profile can be scaled up or down depending on identified military needs. Assets would be owned jointly via an intergovernmental institution that would also be open to the participation of the U.K. and Norway, for instance.

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