How Europe can mitigate its mighty defence cost challenges

Increased defence spending by European countries will hit households hard. We're not overly convinced by the positive effects on GDP growth. But if Europe works more closely together, member states could significantly mitigate the downside. It's another challenge for NATO members, currently meeting in the Hague

NATO Secretary General Mark Rutte

Why the positive effect to GDP is limited

No one is immune to the devastating pictures we see daily as war and conflict rage from Europe to the Middle East and beyond. But it's my job, as an economist, to focus not on the human cost but the financial one. And the economics of defence are more in focus than ever since Donald Trump demanded more spending from his NATO allies.

Increased European defence spending has a potential economic upside. The European Commission sees GDP growth 0.3-0.6% higher by 2028, while the Kiel Institute for World Economy estimated a 0.9% to 1.5% GDP effect of defence spending going from 2% to 3.5% of GDP.

We are with the European Commission on the lower side of the estimate. The high import share is the most important reason. Remember, defence spending comprises personnel, premises and equipment (tanks, jets, ammunition, telecommunications, and so on). The share of the latter in the total ranges from 15% in Belgium to 50% in Poland. It tends to be higher for countries with higher and/or increasing defence spending as a share of GDP.

We expect additional spending to be more oriented towards equipment, where underinvestment has been significant. For the economic impact, it's important that of all the military equipment to support Ukraine, 78% was acquired from non-EU producers, so the **import share** of the additional spending will be high. The defence industry is small; in 2024, it made up 0.5% of industrial production. It will take time for it to scale up, which limits the economic upside as far as manufacturing is concerned.

The positive GDP effect is higher if the additional spending is **debt-financed**, which we expect to be the case for the first couple of years. This approach makes sense, as budget cuts or tax increases are usually politically painful, while the high import share would risk switching domestic consumption for imports, denting the economy. However, over time, there's no economic justification for higher European deficit norms because of higher defence spending. It will be recurring government spending, so it should be covered by recurring government income or cuts to spending elsewhere. This implies that **over time,** the positive effect on GDP will come down versus the 2028 effect.

Why European households will pay the price

So the upside for the economy is limited. But I will switch to the household perspective to explain the bad news. European countries currently spend about 2% of their GDP on defence. That will go to somewhere between 3.5% and 5% of GDP. It's a bit like your insurance premium doubling in price. Or, to be more precise, the US is no longer willing to pick up a significant part of the bill and is forcing Europe to pay up. European governments must spend the additional 1.5% (or more) of GDP.

This implies one of two options: it cannot be spent on healthcare, social security or education and comes in the form of cuts to these areas. Alternatively, it can come in the form of higher taxation, so European consumers will be spending less on other stuff. In practice, it will probably be a mix of the two. But make no mistake, European households will pay for it.

This is not to say that the money should not be spent. With the US making clear it's no longer willing to pick up the bill and with wars going on in Ukraine, Israel and Iran, it's clear that not spending on defence would risk far higher costs. Like our insurance premium, we will simply have to pay.

Blom: Europe needs new thinking to mitigate Trump's costly defence demands

Watch Marieke Blom argue that if Europe is being forced to massively expand its defence spending, then the continent needs a new way of thinking.

Watch video

It is economically more significant than the trade war

What I find fascinating is that the newsflow on the economic price Europeans will have to pay for defence is dwarfed by the attention on the trade war, because extra defence costs will hit consumers far harder. Trade tariffs will likely impact goods trade with the US. But, net, American demand for goods from Europe 'only' equals about 2% of our GDP. So we, and many others, have estimated the short-term cost of the trade war to be below one per cent of GDP.

Clearly, the way in which trade and defence impact Europeans is completely different. The trade war impact comes via lower job growth and purchasing power over the short term. Higher defence spending affects households via worsening public services, social security or higher tax bills, changing the composition of the economy over time. The order of magnitude, a recurring 1.5 to 3 % of GDP, is a much larger economic challenge than the one-off trade war effect of below 1% of GDP.

Mitigation requires cooperation

Given that order of magnitude, it's important to think about ways to significantly mitigate the negative impact. So here's the positive economic lens:

Procurement.

Europe can procure defence material together. The Draghi and Letta reports point to the costs of countries buying separately and not making use of economies of scale. The savings from a common approach have been estimated at 18 to 57 billion euros per year. The most important effect of joint purchasing is that with the same amount of spending, more security can be bought.

In essence, it's a way of lowering the required share of GDP to achieve a desired level of security. For now, it's all about 3.5% or 5%, but we'd expect the debate to gradually shift more to defensive capabilities rather than spending norms.

Borrowing

When Europe borrows, it can do that together. As we've argued before, common borrowing brings average financing costs down. This is relevant for the first couple of years, in which defence spending is debt-financed. But it's also relevant longer term, as another break in the taboo on joint debt issuance can help initiate a discussion on other benefits of joint European debt. This has the potential to lower the cost of funding for the entire economy.

Production

Europe can increasingly produce defence materials and services internally. Producing here has two benefits: firstly, it means the money is spent within the EU. This can, over time, support European manufacturers and will lower the import share. Secondly, defence materials are often Research & Development intensive as it's all about being smarter and faster than others. Making equipment here can help bring knowledge spillovers to our own continent. The Draghi report pointed out that the US has a far larger R&D share in defence spending.

In addition, the US Department of Defence is spending significant amounts on AI; it's clearly not just about physical stuff. This can help support Europe's digital ambitions. The R&D and AI effect of spending in Europe can support productivity and thus support growth and purchasing power in the long run.

The combined effect of common procurement, common borrowing, European production, and higher R&D spending can offset a significant part of the costs for Europeans. In fact, this is exactly what the European Commission is proposing.

If you wonder whether Europeans are ready for this, knowing that trust in Europe is at a record high is important. 52% of Europeans say they trust the European Commission, while 36% and 37% of Europeans say they trust their national government and parliament, respectively. Also, eight in ten support a common defence and security policy among Member States – the highest result since 2004.

But European governments may need a bit of a push. One European government official explained to me: '*All great to do defence together, as long as we do it like my home country*'.

It's high time to get past this, as the economic benefits of a common approach can be significant.

Author

Marieke Blom
Chief Economist and Global Head of Research
marieke.blom@ing.com

Disclaimer