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SECURING EUROPE'S FUTURE TOGETHER

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References

This is a translated version of the original German-language chapter "Europas Zukunft gemeinsam sichern", which is the sole authoritative text. Please cite the original German-language chapter if any reference is made to this text. This translation was generated using AI.

KEY MESSAGES

↘ The European Union is facing considerable challenges, among them weak productivity growth compared to the US, and an increasing geopolitical tensions.

↘ Trade barriers and a different regulatory framework prevent the EU from reaching its economic potential. Reducing territorial supply restrictions can improve the integration of the European single market.

↘ Joint procurement of defence equipment and promotion of military innovation can significantly strengthen European defence capabilities.

THE MOST IMPORTANT POINTS IN BRIEF

The European Union (EU) is the world's second largest economic area. The **common European single market**, a cornerstone of EU integration, **has led to deep economic ties among member states**. This chapter addresses **two key challenges** currently facing the EU. On the one hand, **productivity growth** has **slowed significantly** in recent decades compared to the US. On the other hand, **geopolitical tensions have increased** and the multilateral world order is under increasing pressure.

High trade barriers remain in the European single market for goods and services, **preventing the EU** from **fully** reaching its **economic potential**. **Capital markets are** also **fragmented**, characterised by differing regulatory frameworks and an incomplete banking union. This is **dampening cross-border investment and economic growth in the EU**. In addition, US trade and foreign policy is currently volatile and unpredictable. The **deteriorating security situation**, particularly in light of Russia's attack on Ukraine, poses a direct **threat to the EU**. There is a **considerable need to catch up in terms of military capabilities in many EU countries**. A lack of coordination among European countries and a **strong preference** for **national suppliers** in the procurement of defence equipment also **lead to inefficiencies and high costs**.

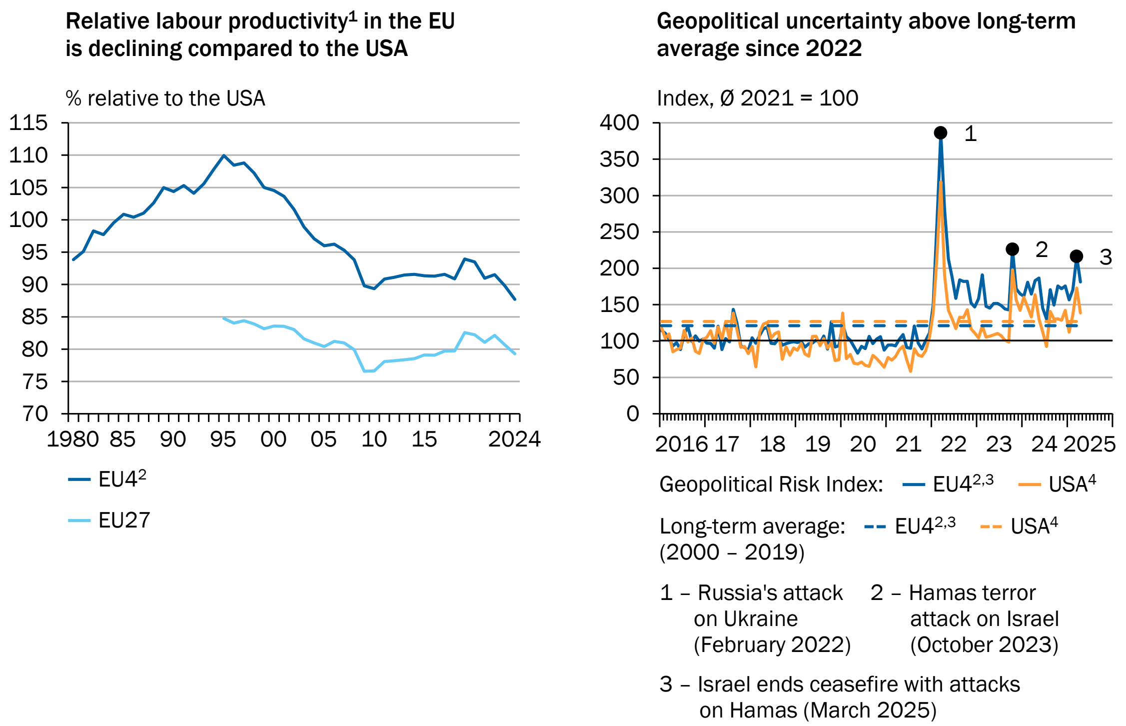
There is clear European added value in the four fundamental freedoms of the internal market and European security. **EU-wide solutions are superior to action by individual member states.** In order to meet the challenges mentioned above and shape Europe's future together, it is **crucial to deepen the European internal and capital markets.** This can lead to a more efficient allocation of resources and increase productivity growth. Specifically, this includes **reducing territorial supply restrictions** and harmonising regulations, for example by **introducing a "28th regime" in company law.** In the area of capital markets, **integrating capital market supervision** and **improving venture capital financing** are important in order to reduce the innovation gap with the US. The **creation of a "European Safe Asset"** would strengthen the attractiveness of the euro at the international level, but should be designed with the sustainability of public finances in mind. Finally, strengthening European defence capabilities requires **overcoming the fragmentation of the internal defence market**, **coordinating the procurement of defence equipment at the European level** and **promoting innovation in the defence sector**.

I. INTRODUCTION

163. The **European Union** (EU) is the second largest **economic area in the world**. It is home to 450 million people and 26 million companies. The **common European single market** is a **cornerstone of EU integration** (Treaty of Lisbon, Article 3) and enables the **free movement of goods**, **services**, **people and capital** within the EU. It has led to deep economic integration among member states and significant increases in prosperity (in 't Veld, 2019; Felbermayr et al., 2022; Fontagné and Yotov, 2024).

164. This chapter addresses two key challenges currently facing the EU. Firstly, **productivity growth** has **slowed in recent decades**. This is exemplified by the weaker development of labour productivity in the EU compared to the US. ↘ CHART 44 LEFT Low levels of innovation, fragmented capital markets and divergent regulatory frameworks within member states all contribute to these developments (Draghi, 2024a; Letta, 2024). Secondly, **the EU's security situation** has **deteriorated fundamentally**. This change is reflected in the geopolitical risk index for the EU, which has been well above its long-term average **since Russia's**

↘ CHART 44
Challenges for the EU



1 – GDP in purchasing power parity per hour worked. 2 – Germany (from 1991), France, Italy, Spain. 3 – The index reflects the results of automatic text searches in five major European newspapers. It is calculated based on the proportion of articles on geopolitical events in the total number of articles in each newspaper for each month. The country indicators are weighted according to the GDP. 4 – The index reflects the results of automatic text searches in ten newspapers in the United States. It is calculated based on the proportion of articles on negative geopolitical events in the total number of articles in each newspaper for each month.

Sources: AMECO, Bondarenko et al. (2024), Caldara and Iacoviello (2022), IMF, own calculations

attack on Ukraine. ↘ CHART 44 RIGHT In addition, US President Donald Trump's trade and foreign policy is erratic and unpredictable (GCEE Spring Report 2025 item 13). The strategic rivalry between the US and China is putting additional pressure on the multilateral world order. These geopolitical tensions have exacerbated the fragmentation of the global economy that had already begun (Fernández-Villaverde et al., 2024; Gopinath et al., 2025) and are weighing on the internationally closely integrated European Economic and Currency Area.

165. From an economic perspective, **tasks** should **be assigned to the European level** if this offers **efficiency or cost advantages over purely national action** (Alesina et al., 2005; Bassford et al., 2013; Weiss et al., 2017; Heinemann, 2020; GCEE Annual Report 2020 item 253). Examples of areas that create **European added value** include, in particular, the **internal market and joint defence**. In order to address the challenges mentioned above, **European cooperation** in these two areas should be further expanded. This is because the internal market is not yet complete (IMF, 2024), which means that the EU **is not yet fully reaching** its economic **potential**. **Deepening the European single market** can lead to a more efficient allocation of resources and increase overall economic production. In addition, in view of geopolitical tensions and the erratic and unpredictable US policy under Donald Trump, it is important **to strengthen European defence capabilities comprehensively**.

166. Cross-border trade in goods and services within the European single market has increased significantly over the last three decades, for example through the removal of trade barriers in the course of standardising product norms, thereby stimulating **economic growth in the EU**. ↘ ITEM 171 However, trade barriers within the EU still exist. Regional trade flows, which are strongly influenced by national borders, indicate that the internal market is incomplete (Santamaría et al., 2020). This shows that the **potential of the internal market** has **not** been **fully exploited**. ↘ ITEM 173 **Further deepening** would bring significant economic benefits for member states. ↘ ITEMS 174 F. A starting point for deepening the internal market and removing trade barriers could be the elimination of different packaging and labelling regulations, which contribute to **territorial supply constraints** and restrict trade between member states. ↘ ITEMS 189 FF. **A further step would be a uniform company law**, a so-called EU-wide "28th regime". ↘ ITEMS 194 FF. This would enable in particular small and medium-sized enterprises to overcome differences in the legal systems of the 27 member states and thus deepen trade in the internal market.

167. The free movement of capital is a central pillar of European integration and plays an essential role in strengthening Europe's economic performance. However, the **European financial architecture** is currently **bank-based and highly fragmented**. The share of bank financing of companies is high in Europe, and an expansion of this type of financing is unlikely to lead to strong growth impulses (GCEE Annual Report 2023 box 14). Market-based financing instruments such as stock markets and venture capital, on the other hand, are particularly suitable for financing young growth companies (start-ups and scale-ups).

168. In **order to facilitate private investment and promote sustainable growth**, comprehensive **harmonisation of company**, **insolvency and tax law** is needed, as well as a targeted reduction of bureaucratic hurdles. At the same time, **capital market supervision** should **be harmonised across Europe** through a strengthened and reformed European Securities and Markets Authority (ESMA), and national duplication of supervision should be abolished. ↘ ITEM 206 **Expanding venture capital financing** – especially for start-ups – is also important in order to close the innovation gap with the United States. ↘ ITEM 200 Last but not least, the **creation of so-called "European safe assets"** is being discussed, for example in the form of synthetic safe bonds or jointly issued Eurobonds, in order to strengthen the euro at the international level. If such an asset is designed to be incentive-compatible, it could significantly strengthen the importance of the European capital market. ↘ ITEM 207

169. **European defence capability** is a **European public good**. ↘ ITEM 180 In view of the threat posed by Russia's ongoing aggression and other security policy challenges, European defence capabilities should be so that Europe can act within the transatlantic alliance. ↘ ITEMS 181 FF. To this end, the fragmentation of the internal market for defence equipment must be overcome and production capacities must be aligned with the changing needs of EU member states and their partners. ↘ BOX 11 At the same time, it may be useful to establish a permanent instrument for joint European procurement of defence equipment. ↘ ITEMS 229 FF. An essential part of forward-looking, strategic defence planning is to promote innovation in the area of defence and increase investment in research and development. ↘ ITEMS 239 FF. The financing of common defence capabilities should be better coordinated and secured at the European level without jeopardising fiscal sustainability. ↘ ITEMS 243 FF.

170. **Far-reaching reforms** are **needed in the EU to strengthen the European single market and defence capabilities**. With a **focus on the four fundamental freedoms** ↘ GLOSSARY **of the single market and European security**, this chapter focuses on policy areas where there is **European added value** and EU-wide solutions are superior to national action.

The challenges mentioned above are easier to tackle if the proposed measures are accompanied by **reforms to the way the EU works**. Draghi (2024b) makes several suggestions in this regard: Reforming decision-making in the EU may be useful in order to address the challenges mentioned above quickly. **Enhanced cooperation** between several member states is a possible solution. The EU Treaties provide for such **a "multi-speed EU"** if at least nine member states are involved, the European Parliament consents and is legally accompanied by the European Court of Justice (ECJ) (Draghi, 2024b; Article 20 TEU, Article 329 TFEU). One example of such a cooperation is a standardised electronic registration form for the posting of workers in the participating countries (Bauer, 2024). In addition, in certain areas it may make sense for a smaller group of countries, ideally led by the larger EU members, to form a "coalition of the willing" and press ahead with integration, for example in harmonising rules. However, such alliances should always be open to as many countries as possible.

II. STARTING POINT: EUROPE'S POTENTIAL IS NOT BEING EXPLOITED

1. Fragmented internal market hinders economic dynamism

171. Over the past decades, **European integration** has led to significant economic interdependence among member states and to considerable **increases in prosperity**. Studies that examine the economic effects of EU integration using structural models conclude that EU integration to date has had positive effects on growth (in 't Veld, 2019; Felbermayr et al., 2022; Fontagné and Yotov, 2024). Further econometric estimates also suggest that the volume of trade between two EU member states is on average between 52 % (Nagengast et al., 2025) and 63 % (Fontagné and Yotov, 2025) higher than it would have been without EU membership.

172. However, the **potential of the EU single market** ↘ BACKGROUND INFO 5 has **not** yet **been fully realised**. Despite significant progress in the free movement of goods and services since the establishment of the European Communities, there are still high barriers to trade between member states. In addition, the defence sector has so far been largely excluded from EU integration. This leads to inefficient procurement and production and increases the cost of European rearmament. ↘ BOX 11 Limited progress has been made in integrating financial markets. The banking union has yet to be completed, and few of the targets set for the capital markets union have been achieved.

↘ BACKGROUND INFO 5

Background: European Single Market

The European Single Market ensures the **free movement of goods, services, capital and labour** within the European Union (EU). It is based on the **Treaties of Rome of 1957**, which laid the foundations for the European Economic Community (EEC). With the **Agreement on the European Economic Area (EEA)** signed in 1992, the single market was **extended to non-EU member states.** The **EEA states** consist of the **27 member states of the EU as well as Norway, Iceland and Liechtenstein.**

↘ BOX 11

Focus: Obstacles to the establishment of a European internal market for defence

The **European market for defence equipment** is extremely fragmented (Wolff et al., 2025). National industrial policy objectives often go hand in hand with prioritising national producers and contribute to the fragmentation of the single market (Clapp et al., 2025). This structure gives defence companies considerable market power, which often leads to excessive procurement costs compared to a competitive market. In addition, fragmentation means that production capacities in the EU are not available to the extent and at the speed currently required by individual member states (European Commission, 2025a).

The Treaty on the Functioning of the EU contains an exemption for the procurement of defence equipment (Article 346 TFEU). It allows member states to exempt military procurement from the rules of the EU internal market on grounds of national security (Commission of the European Communities, 2006). This includes, in particular, the awarding of defence contracts. This has so far slowed down the emergence of a fully integrated European defence internal market. The article was introduced to enable member states to safeguard their essential security interests despite the rules of the EU internal market (Deutscher Bundestag, 2011). If such a market were created, it could enable economies of scale through improved networking and increase competition within the EU (Quinet et al., 2025).

In order to ensure cost-effective strengthening of defence capabilities, further **integration of the European defence market** should **be pursued.** This integration could also trigger consolidation of the defence industry, with inefficiently producing companies being forced out of the market. However, this could create incentives for the creation of centralised weapon systems for the entire EU, so that numerous similar weapon systems with different specifications would no longer be manufactured in parallel. A more specialised and division-of-labour-based European defence industry would also significantly improve its competitiveness vis-à-vis global players.

Complex and inconsistent national legislation is considered a key obstacle to investment and entrepreneurial activity in the European defence sector (KPMG, 2025). In particular, national regulations in the areas of procurement, transfer guidelines and export controls hamper cross-border cooperation in the European defence sector and increase the regulatory burden on industry (Clapp et al., 2025). The EU has already taken steps towards harmonisation in this area. New procurement regulations aim to create a uniform procedure and facilitate cross-border competition (Clapp et al., 2025). In the area of licensing, simplified procedures are intended to facilitate the intra-Community transfer of defence equipment and thereby strengthen supply chains within the EU (European Parliament and Council of the EU, 2012). In addition, the European Council reaffirmed its commitment to the effective implementation of international arms control agreements (Council of the EU, 2025a). Against this background, it is important to examine the extent to which the harmonisation measures taken to date have been effective and how existing regulations can be further harmonised.

Incentives should be created to expand production capacities in areas where industrial potential already exists in the EU. These include modern battle tanks, armoured vehicles, artillery, air defence, drones and electronic warfare systems (Wolff et al., 2025). However, drones in particular are subject to rapid technological development. Stocks can therefore quickly become obsolete, which is why industrial capacities in this area should be flexible and innovation-oriented. The key is not to expand large-scale production facilities, but to create incentives for continuous development and rapid adaptation. In addition, incentives must **be created to** build **production capacities for weapon systems that have previously been manufactured exclusively outside the EU.** These include the latest generation of fighter jets, strategic air defence systems, rocket artillery and heavy transport helicopters (Wolff et al., 2025).

In order for traditional weapon systems to remain operational under the conditions of modern drone warfare and to be able to increasingly integrate autonomous and artificial intelligence (AI)-supported functions (Burilkov et al., 2025), **capacity for key military technologies such as AI** should **be built up** in addition to physical production capacity.

Barriers to trade in goods and services

173. Despite increased trade volumes, **trade barriers** remain **in the internal market**: according to estimates by the International Monetary Fund (IMF), the resulting costs are equivalent to a hypothetical tariff on goods of 44 % (IMF, 2024). In the USA, the corresponding figure for trade in goods between states is only slightly more than 10 %. For services, the IMF calculates an even higher implicit tariff of 110 % on average. Although EU member states perform well overall in the OECD's Services Trade Restrictions Index compared to other countries, according to OECD data barriers to intra-European trade in services remain, though they are lower than those in trade with third countries (Dorn et al., 2024).

174. Fontagné and Yotov (2025) quantify the **potential GDP effects of deeper economic integration in the EU**. ↘ BACKGROUND INFO 6 These effects are positive for all EU member states and in many places would be two to three times higher than the benefits already realised from the single market. ↘ CHART 45 For **small and open economies**, which according to estimates have already benefited most from EU integration, the **potential GDP gains** are **particularly large**, at 7.4 % for Ireland and 7.8 % for Hungary, for example. But larger economies in the EU would also benefit significantly. GDP in Germany, France and Italy would increase by 3.2 %, 2.6 % and 2.2 % respectively. ↘ ITEM 177

↘ BACKGROUND INFO 6

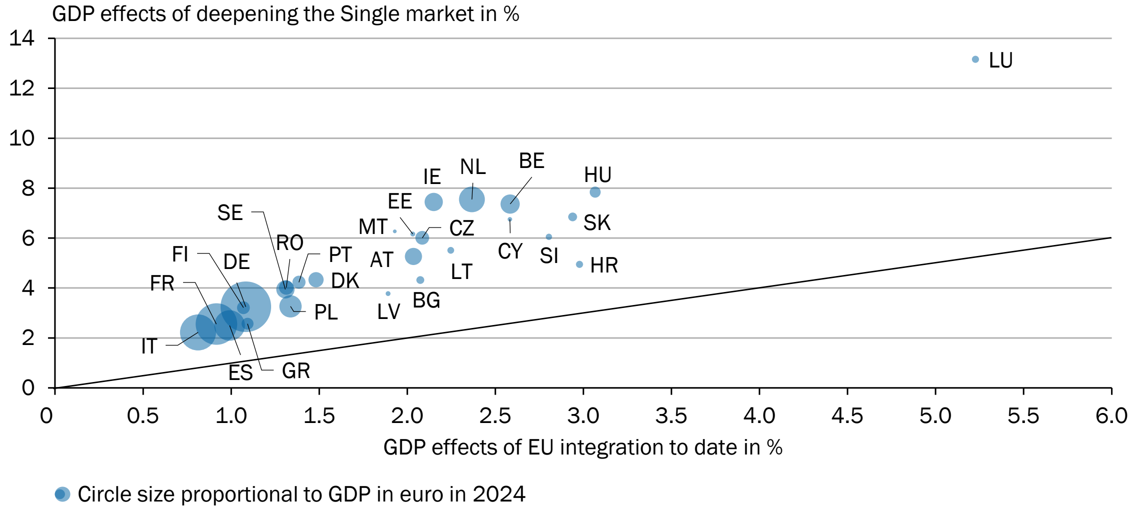
Background: On the model-based calculations of EU internal market potential

Fontagné and Yotov (2025) use a **gravity model** to calculate the **impact of EU integration on bilateral trade flows** within the EU **for each economic sector in each member state. In these models, trade between two economies is explained by their relative size**, **geographical proximity and other determinants.** As a proxy for the potential of the internal market, the authors determine the so-called **"trade cost efficiency bound"** (TCEB) for each economic sector. For reasons of robustness, this is not defined as the largest observed decline in trade costs, but as the 75th percentile of the declines in trade frictions in the various countries attributable to the internal market. The difference between this TCEB and the effects of the EU internal market that have already occurred in an economic sector in a country results in the **"single market potential".** Using a structural trade model, it is then possible to calculate the economic consequences that would arise if the potential of the internal market were to be exploited in every economic sector in every Member State.

175. **Trade barriers in the European single market are non-tariff-based and varied**. According to the European Commission's latest Single Market Report, **companies** particularly **mention differing national regulations** on packaging and labelling, as well as non-regulatory barriers such as territorial supply constraints (European Commission, 2025b). In a recent Eurobarometer survey, **small and medium-sized companies** also cited a lack of understanding of the business environment in other countries and difficult access to information on rules and legal requirements as obstacles to cross-border trade (European Commission and Ipsos EPA, 2025). This is likely to be due to **the coexistence of EU**

↘ CHART 45

Potential for deepening the EU Single market[1]



1 – AT-Austria, BE-Belgium, BG-Bulgaria, CY-Cyprus, CZ-Czechia, DE-Germany, DK-Denmark, EE-Estonia, ES-Spain, FI-Finland, FR-France, GR-Greece, HR-Croatia, HU-Hungary, IE-Ireland, IT-Italy, LT-Lithuania, LU-Luxembourg, LV-Latvia, MT-Malta, NL-Netherlands, PL-Poland, PT-Portugal, RO-Romania, SE-Sweden, SI-Slovenia, SK-Slovakia.

Sources: Eurostat, Fontagné and Yotov (2025)

and national regulations, **e.g. through "gold-plating"** ↘ BACKGROUND INFO 33 (Garicano, 2025). Further specific barriers include **violations of the Cassis de Dijon principle**, ↘ BACKGROUND INFO 7 i.e. the fundamental prohibition of import restrictions within the EU for products already traded in another member state.

↘ PLUSTEXT 7

Background: The Cassis de Dijon principle

The **Cassis de Dijon principle** (principle of mutual recognition) is a **fundamental concept of the European single market.** It states that products that are legally manufactured and marketed in one EU Member State may, in principle, also be sold in any other member state without further technical or legal requirements. Exceptions are only permitted if there are compelling reasons of public interest, such as the protection of public health, the environment or consumers. The origin of this principle lies in a **ruling by the European Court of Justice (ECJ) in 1979** (ECJ Case 120/78). A German retailer wanted to sell a French blackcurrant liqueur ("Cassis de Dijon") in Germany. However, the German authorities refused to allow its import because the liqueur did not comply with national regulations on the minimum alcohol content for spirits. The ECJ ruled that this national regulation constituted an unjustified restriction on the free movement of goods.

176. **Trade barriers hinder economic growth in the EU** for several reasons. For example, non-tariff trade barriers – similar to conventional tariffs – **reduce competition** among companies and **preserve inefficient business models**. In the past, tariffs have often led to a slowdown in GDP growth and productivity (Furceri et al., 2019). Furthermore, **an incomplete internal market hinders** the **efficient allocation of resources** and **prevents the potential of cross-border division of labour from being fully realised**. As a result, companies

miss out on specialisation gains, which also has a negative impact on consumers in the form of higher prices or poorer quality goods and services. Furthermore, non-tariff trade barriers reduce the size of the market and prevent companies from benefiting sufficiently from economies of scale in production. An IMF analysis based on company data shows that the size of the sales market and bank-based sources of financing in particular contribute to lower and more volatile research and development spending by European companies, which can reduce productivity growth (Adilbish et al., 2025).

177. Although **existing trade barriers** have been **known for some time**, it has not yet been possible **to remove** them. For example, almost 20 years after the introduction of the Services Directive in 2006, which aimed to complete the internal market in this area, 60 % of the barriers identified at the time are still in place (European Commission, 2025b). The reasons cited for this are national regulations, such as reporting requirements, necessary permits or the protection of professional titles, which make it difficult for foreign companies to provide services (Dorn et al., 2024). In order to make substantial progress, **concrete measures** must therefore **be prioritised** (Georgieva, 2025).

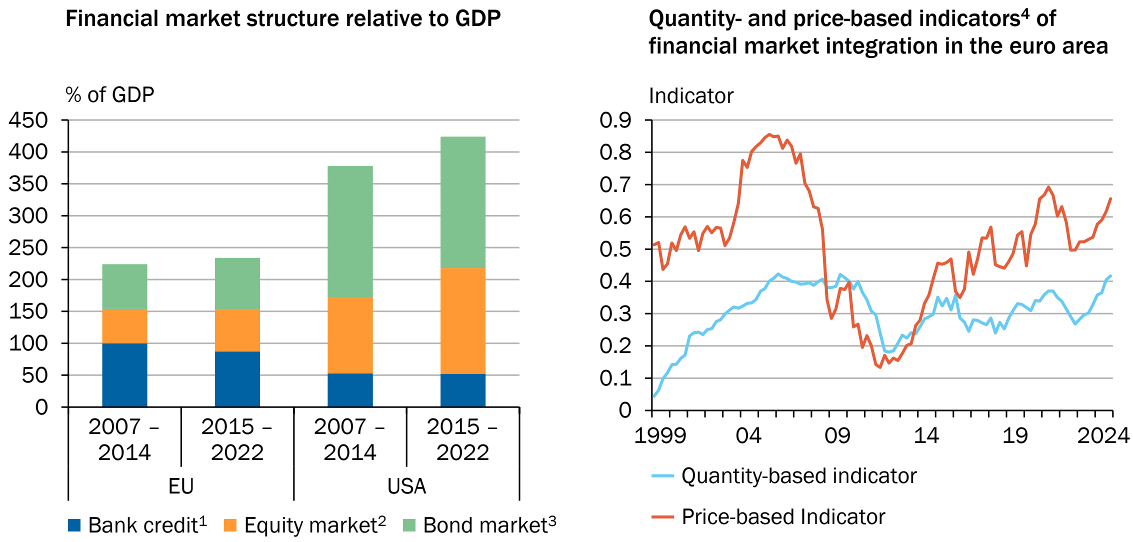
Barriers to financial market integration

178. In addition to a single market for goods and services, the free movement of capital is another important pillar of European integration. The EU needs **deep and liquid capital markets** to generate long-term growth and **finance forward-looking projects** such as the green transition and AI. Currently, the European financial architecture is bank-based and highly fragmented along national lines. ↘ CHART 46 LEFT The banking union is still incomplete and represents a further hurdle to financial market integration (GCEE Annual Report 2023 item 195). A large share of savings in Europe continue to be held in the form of bank deposits, which in turn remain in domestic economies as banks grant few cross-border loans (Balakrishnan and Pradhan, 2025). Overall, progress in the integration of financial markets in the euro area has been modest. Both price- and volume-based indicators have declined over the past two years, with no significant improvement since the introduction of monetary union. ↘ CHART 46 RIGHT Despite extensive regulatory initiatives, cross-border financial flows and risk sharing have largely stagnated (ECB, 2024).

179. A **major obstacle** to cross-border **investment** is **differences in insolvency**, **tax and company law**, which make it difficult to compare investments. For example, the duration of proceedings, costs and recovery rates in the case of insolvency vary greatly between EU member states (EBA, 2020). Improving and harmonising insolvency procedures could improve access to equity and debt finance, reduce financing costs and thus increase economic growth (Simmons et al., 2016; Issam, 2025). The introduction of the International Financial Reporting Standards (IFRS) in the EU in 2005 improved the transparency and comparability of company valuations (see De George et al., 2016 for a review study). As a result, investment by foreign investment funds increased (DeFond et al., 2011), and the valuation of companies using multipliers from foreign peer companies improved significantly after the mandatory introduction of IFRS (Young and Zeng, 2015).

↘ CHART 46

European financial markets remain bank-based and fragmented



1 – Financial resources provided to the private sector by domestic monetary financial institutions (MFIs). 2 – Total value of all listed shares in a stock market at the end of each year. 3 – Sum of outstanding amounts of corporate and government debt securities, as well as securitisation (US data for securitisation available until 2021). 4 – Status: End of each quarter. The quantity-based indicator aggregates five raw indicators. The indicators are cross-border holdings within the euro area relative to total holdings in the euro area. In a fully integrated market, everyone would invest in the market portfolio. All would thus hold a portfolio whose assets are proportional to the total supply of assets in the economy. The price-based indicator of financial integration is formed and aggregated from ten individual indicators for the respective segments, the money, bond, equity and banking markets. The indicators measure price dispersion. The theoretical basis is based on the assumption that assets with identical risk and identical cash flows should have the same price, regardless of the country in which they are issued or traded. For a detailed definition of the volume- and price-based indicators of financial market integration, see ECB (2024).

Sources: ECB, Lannoo et al. (2024)

2. Defence coordination across states is lacking

180. **European defence capability** is **of central importance for security in Europe**. **It has recently become a more prominent topic in security policy discussions**. Defence is a public good and can also be a **European public good**, as the defence capability of individual EU member states may depend on the defence efforts of other member states. In the Maastricht Treaty of 1992, the EU member states set themselves the goal of establishing a common defence policy. The mutual assistance clause in the event of an armed attack on an EU member state in the Lisbon Treaty of 2007 also created a European instrument for risk sharing. ↘ BACKGROUND INFO 8

↘ BACKGROUND INFO 8

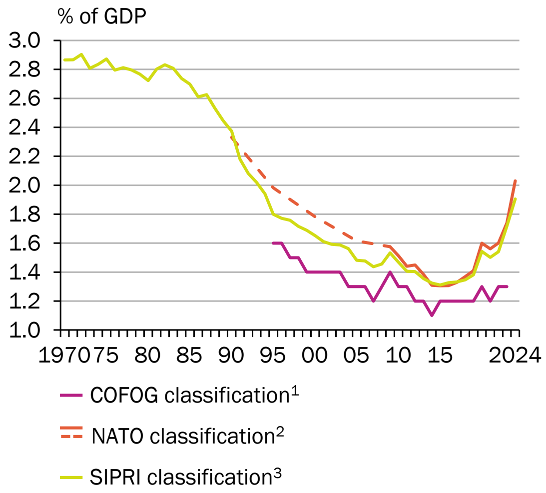
Definition: Mutual assistance clause of the Treaty on European Union

With the Treaty of Lisbon, which was signed on 13 December 2007 and entered into force on 1 December 2009, the European Union created a **collective mutual assistance clause in the event of an armed attack on an EU member state** (Article 42(7) TEU). The assistance does not necessarily have to be military in nature. It can also take the form of diplomatic, technical or medical measures. The mutual assistance clause allows for the specific characteristics of member states to be taken into account, such as the German parliamentary reservation (BVerfG, 1994) or Austria's military neutrality (Bundesverfassungsgesetz Österreich, 1955). To date, the mutual assistance clause has been invoked once, by the French government after the terrorist attacks in Paris in November 2015 (Rathke, 2015). The EU member states responded by expressing their solidarity and support. The French government subsequently called on its European partners to increase their financial contribution to the international fight against terrorism, which enabled the expansion of personnel for the military counter-terrorism operation "Opération Sentinelle" (EEAS, 2022).

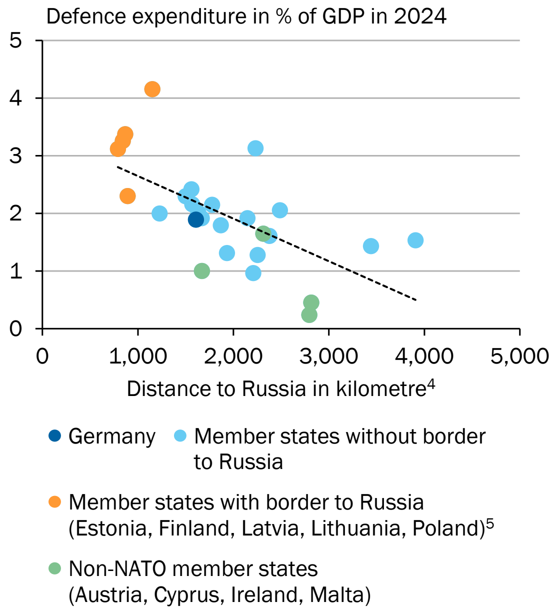
181. Russia's war of aggression against Ukraine has shifted the priorities of national armies in the EU back towards national defence. **Russia's ongoing aggression**, including airspace violations, military exercises and alleged acts of sabotage against critical infrastructure in EU member states such as Germany, the Baltic states, Finland and Poland, as well as in Norway and the United Kingdom (Edwards and Seidenstein, 2025), **poses a direct threat to the EU and its allies**. Russia has massively expanded its military production and is operating a war economy (Burilkov et al., 2025; Snegovaya et al., 2025). In 2025, Russia plans to increase its military spending to an estimated 7.2 % of GDP (Cooper, 2025).

↘ CHART 47
Defence expenditure in the EU27 member states

Defence expenditure declined until 2015, then rose significantly thereafter



Geographical proximity to Russia is reflected in higher defence expenditure



1 – Classification of the Functions of Government, edition 1999. 2 – Member states of the EU, which are also members of the NATO; since 1990: Belgium, Denmark, France, Germany, Greece, Italy, Luxembourg, Netherlands, Portugal, Spain; since 1999: plus Czechia, Hungary, Poland; since 2004: plus Bulgaria, Estonia, Latvia, Lithuania, Romania, Slovakia, Slovenia; since 2009: plus Croatia; since 2023: plus Finland; since 2024: plus Sweden. Only 5-year averages are available for the period from 1990 to 2009. 3 – Value for 2024: calculation by aggregation across member states. 4 – Airline distance between the respective capital city and Moscow. 5 – Lithuania and Poland don't share a direct border with Russia, but rather with the Kaliningrad Oblast.

Sources: AMECO, Eurostat, NATO, SIPRI (2025), World Bank, own calculations

182. Part of the current geopolitical changes is that the interaction between the US and the EU in the security sector is changing. The **EU remains heavily dependent on NATO**, and in particular on the US, **for its defence capabilities**, not least because of the US nuclear umbrella. At the same time, changing priorities and decision-making processes, as well as the erratic and unpredictable alliance policy of the US, show that Europe **must play** a **greater** role and **take on more** responsibility within the Western alliance in order to strengthen its own security in the long term, reduce its dependence in important political and technological areas, and be an attractive partner in the Western alliance.

183. **Defence spending in the EU** has been **much lower since the end of the Cold War than it was before**. ↘ CHART 47 LEFT While it averaged just under 2.8 % of GDP between 1970 and 1989, according to the Stockholm International Peace Research Institute (SIPRI), it had fallen significantly to around 1.3 % of GDP by the mid-2010s. Only since 2015, one year after Russia's annexation of Crimea, defence spending has risen again, reaching 1.9 % of GDP in 2024. A similar picture emerges when looking at defence spending according to the NATO definition or the classification of government functions (COFOG), which use different definitions and recording methods. ↘ CHART 47 LEFT ↘ BACKGROUND INFO 9

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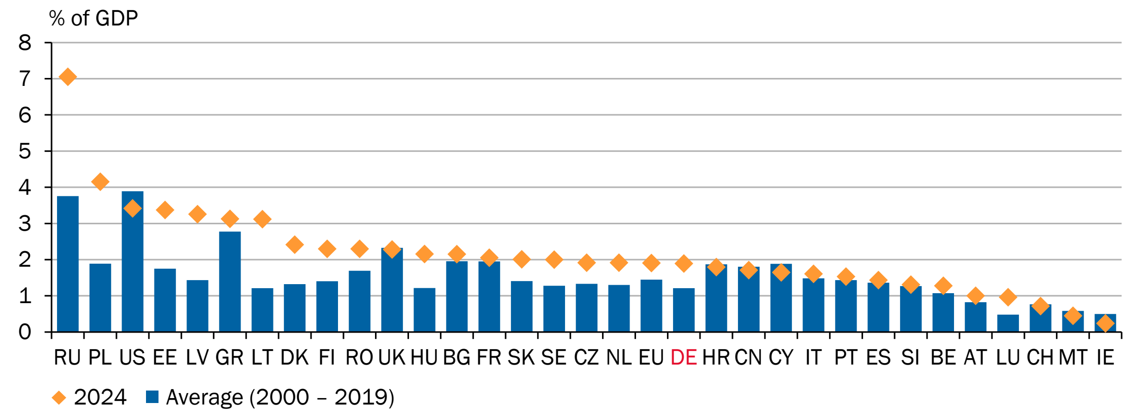
↘ BACKGROUND INFO 9

Definition: Defence expenditure in various classifications

The **SIPRI definition** covers internationally comparable defence expenditure and includes personnel, operation and maintenance, procurement, military research and development, military infrastructure and military aid. Expenditure on civil defence and ongoing costs of previous military activities are not included. The **NATO definition** divides member states' defence expenditure into personnel, equipment, infrastructure and other expenses. It is broader than the SIPRI definition and also includes military pensions and military health care (Clapp, 2025a). Due to differences in data sources and definitions, the figures from NATO and SIPRI are not directly comparable (SIPRI, 2017). The **COFOG definition** covers military and civil defence, foreign military aid, defence-related research and development, and other defence expenditure not classified elsewhere. It is therefore narrower than the definitions mentioned above. These three definitions refer to **defence expenditure in the narrower sense**, i.e. military and directly defence-related activities. **Defence expenditure in the broader sense** also includes measures to strengthen the resilience of society as a whole, such as the protection of critical infrastructure, cyber defence, civil preparedness and the promotion of the defence industry.

184. A look at **defence spending within the EU** according to SIPRI data shows that **countries geographically close to Russia**, in particular the Baltic states, Finland and Poland, **spent more on defence than the EU average in 2024**. ↘ CHART 47 RIGHT In contrast, defence spending by member states further away from Russia, such as Spain and Portugal, or with traditional neutrality, such as Austria and Ireland, were significantly below this level. The target agreed at the NATO summit in 2014 to increase defence spending to at least 2 % of GDP by 2024 was achieved by 13 EU member states that are also NATO members. ↘ CHART 48 The new target agreed at the NATO summit in 2025 to further increase this ratio to 3.5 %

↘ CHART 48
International[1] defence expenditure according to SIPRI classification



1 – RU-Russia, PL-Poland, US-USA, EE-Estonia, LV-Latvia, GR-Greece, LT-Lithuania, DK-Denmark, FI-Finland, RO-Romania, UK-United Kingdom, HU-Hungary, BG-Bulgaria, FR-France, SK-Slovakia, SE-Sweden, CZ-Czech Republic, NL-Netherlands, EU-European Union (27 member states), DE-Germany, HR-Croatia, CN-China, CY-Cyprus, IT-Italy, PT-Portugal, ES-Spain, SI-Slovenia, BE-Belgium, AT-Austria, LU-Luxembourg, CH-Switzerland, MT-Malta, IE-Ireland.

Sources: SIPRI (2025), own calculations

of GDP by 2035 (NATO, 2025) refers, as in the previous target, to defence spending in the narrow sense. Poland already met this target in 2024. In addition, 1.5 % of GDP is to be spent on defence in the broader sense. ↘ BACKGROUND INFO 9

185. **At the national level**, following Russia's attack on Ukraine, some EU member states have **significantly increased** their **defence spending** ↘ CHART 48 or adapted their defence strategies to the new realities. ↘ BACKGROUND INFO 10 An important step towards increasing efficiency would be **to better coordinate weapons systems and defence research**, so that production and development are more targeted and cost-effective. This coordination **does not necessarily** require **joint procurement or joint financing at EU level**. Joint procurement and financing measures at EU level could generate greater social value in the long term, as **costs and benefits are internalised more efficiently across member states**.

↘ BACKGROUND INFO 10

Background: National changes in defence since 2022

At national level, some member states have **significantly adjusted** their **defence strategies and defence spending** over the past three years. European countries such as Poland and France have responded to Russia's attack on Ukraine with legislation. Poland's Homeland Defence Act of 11 March 2022, for example, aims to comprehensively strengthen the armed forces, including by increasing active personnel to 300,000 and increasing defence spending (The Chancellery of the Prime Minister of Poland, 2022). The French government, which sets out multi-year military programmes in law, plans to increase spending by 40 % by 2030 compared to the 2019–2024 military programme (Ministère des Armées France, 2023). In addition, three countries have set up debt-financed special funds to increase defence spending: Germany's Bundeswehr special fund worth €100 billion, Sweden's fund worth around €27.0 billion (300 billion Swedish kronor; Svantesson and

Jonson, 2025) and Denmark's special fund worth around €6.7 billion (50 billion Danish kroner; Danish Ministry of Defence, 2025). In addition, Germany has a defence sector exemption, whereby expenditure exceeding 1 % of GDP can be financed by debt without being counted towards the permissible net borrowing under the debt brake. ↘ ITEM 498

III. DEEPENING THE INTERNAL MARKET

186. **Reforms** in the areas **of goods**, **services and capital** are **necessary** in order to **exploit the potential of the internal market**. In its new **Single Market Strategy**, the European Commission has made proposals to remove what it considers to be the ten biggest barriers to trade (**"Terrible Ten"**) for goods and services. ↘ ITEM 187 Specific proposals include the removal **of territorial supply constraints** ↘ ITEMS 189 FF. and differing national regulations that make it difficult to establish and run cross-border companies. These could be overcome by a **so-called 28th regime** ↘ ITEMS 194 FF. In the area of capital markets, **reform of capital market supervision** is of great importance. ↘ ITEM 206 **Improving risk capital financing** – especially for scale-ups – is also important in order to reduce the innovation gap with the US. ↘ ITEMS 200 FF. In addition, the **creation of a "European Safe Asset"** could strengthen the attractiveness of the euro at the international level. ↘ ITEMS 207 FF.

1. Trade barriers for goods and services

187. The European Commission's Single Market Strategy ↘ TABLE 15 can be broadly **divided** into **three categories**. Firstly, there are a number of **concrete policy proposals** aimed **at addressing specific barriers**. These include, for example, a digital product passport to overcome the trade-restricting effect of different national regulations on packaging, labelling and disposal. The aim is to remedy the fragmentation of the internal market due to differing information requirements or recycling procedures between member states. This would enable companies to produce for a larger sales market. Secondly, the Commission is making **general proposals to overcome specific barriers**. One example is the Commission's proposal to supplement company law (known as the "28th regime") in order to facilitate the cross-border establishment and management of companies (Letta, 2024). This is intended to make it easier for small and medium-sized enterprises in particular to access the internal market. In the retail sector, there are plans to reduce territorial supply constraints, which, according to a Commission study, lead to higher prices for consumers (European Commission, 2020a), if this is not possible through competition law alone. And thirdly, the strategy contains very **vague proposals** that only refer to **general trade barriers**. The intention to reduce unnecessary administrative burdens in omnibus proposals in order to reduce trade barriers in the form of overly complex EU regulations is one example of this. The Commission also proposes sector-specific initiatives to reduce trade

barriers in service sectors such as construction, delivery services, and business and industrial services.

188. **The European Commission** acts as the "guardian of the treaties" and **ensures** that **the rules of the internal market are applied correctly**. However, the member states also bear responsibility for ensuring that **the internal market functions without trade barriers**. Different national preferences, e.g. regarding information requirements in merchandise trade, are understandable and do not fundamentally conflict with the internal market. However, **additional national rules** should be avoided, particularly **when transposing EU directives into national law**, so as not to create new trade barriers. In order to prevent so-called gold-plating, identify existing trade barriers or prevent new ones, the European Commission has proposed in its new strategy to establish a high-level "single market sherpa" in each Member State. However, it seems more effective to appoint a single representative instead, who would represent the interests of the internal market vis-à-vis the member states.

↘ TABLE 15

European Commission's Single market strategy

Trade barrier	Policy proposal by the European Commission
Specific trade barrier, specific policy proposal	
Fragmented rules on packaging, labelling and waste	Implement the Digital Product Passport for digital labels and product compliance; harmonise and simplify extended producer responsibility schemes for end-of-life products.
Burdensome procedures for temporary posting of workers	Support adoption of the e-declaration for posted workers and social security coordination; facilitate temporary cross-border provision of posted workers; pilot and deploy the European Social Security Pass (ESSPASS).
Specific trade barrier, general policy proposal	
Complicated business establishment and operations	Establish a new “28th regime” for EU company law; revise the Commission Recommendation on business transfers.
Lack of ownership by Member States	Appoint a high-level Single Market representative (“Sherpa”); organise high-level political meetings of the Single Market Enforcement Task Force (SMET); reinforce preventive mechanisms on EU level.
Territorial supply constraints (TSCs)	Develop tools against unjustified Territorial Supply Constraints beyond situations prohibited by competition law.
Long delays in standard-setting	Review the Standardisation Regulation; allow the Commission to establish common specifications when needed.
General trade barrier, general policy proposal	
Limited recognition of professional qualifications	Make recognition faster and more efficient using digital tools and automatic procedures; explore common rules for recognition of third-country nationals.
Overly complex EU rules	Reduce unnecessary administrative burdens identified in Omnibus proposals; simplify and streamline the EU Public Procurement framework.
Outdated product rules and lack of product compliance	Better coordinate EU and national customs and market surveillance authorities and potentially establish an EU market surveillance authority; create a legal framework for refurbished and repaired products; strengthen requirements for conformity assessment bodies.
Restrictive and diverging national services regulation	Facilitate temporary provision of cross-border services, potentially including harmonisation of service authorisations and certification schemes; address challenges in sectors such as construction, retail, delivery, business and industry services.

Source: European Commission

Reducing territorial supply constraints

189. Territorial supply constraints (TSCs) are **practices used by manufacturers** that **restrict** the free **movement of goods** within the EU. Large, typically multinational manufacturers of branded products, particularly in the food, drugstore and hygiene sectors, use TSCs to ensure that their products are sold at different prices in different EU countries, thereby increasing their margins. They do this by contractually preventing wholesalers or retailers from purchasing their products elsewhere at lower prices. For example, a large Belgian brewer prevented cheaper imports of a popular Belgian beer that supermarkets and retailers in the neighbouring Netherlands wanted to purchase by changing the packaging to make it harder to sell and threatening Dutch wholesalers with sanctions if they supplied Belgian customers (European Commission, 2020a).

190. The principle of **freedom of contract** applies in the EU. Companies should decide with whom they trade on the basis of economic considerations. However, **territorial supply constraints** can be considered **violations of the prohibition of discrimination** on grounds of nationality in the EU (Article 18, second part, TFEU), which are based on the exploitation of market power but are often difficult to address using EU competition law (Letta, 2024).

191. **Territorial supply constraints are widespread in the EU**. A study by the European Commission, which examined six products, including breakfast cereals, soft drinks and detergents, in twelve member states, concludes that **almost half of the retailers surveyed** had **experience of territorial supply constraints**, mostly due to a manufacturer's refusal to supply a product. The **soft drinks trade** is **most affected by these restrictions**. Overall, for the product range and countries considered, **the removal of territorial supply constraints** would **lead** to **total savings of €14.1 billion** for private households (European Commission, 2020a). This is because the abolition of supply restrictions would reduce the purchase prices paid by retailers and wholesalers and, in a fully competitive market, these savings would also be passed on to consumers.

192. **Competition law measures** are **not always sufficient** to prevent direct territorial supply restrictions, since **EU competition law** only **applies** if **territorial supply restrictions are part of anti-competitive agreements or** are **implemented unilaterally by dominant market players** (European Commission, 2025b). In 2019, for example, the European Commission fined the Belgian brewer €200 million in the above-mentioned case for restricting the volume of beer exports from the Netherlands to Belgium. However, the decisive factor here was that the European Commission had identified AB InBev as having a dominant market position under Article 102 TFEU (Ashton, 2025).

193. In its Single Market Strategy, the European Commission announces that it will develop **tools to combat territorial supply constraints that** cannot be **addressed by competition law**. For example, the **principle of non-discrimination** enshrined in the Geoblocking Regulation could be **extended to transactions between companies (B2B)**. The **Geoblocking Regulation** aims to prevent unequal treatment of customers from different EU member states on the

basis of nationality, place of residence or place of establishment. Implementation of the Directive is the responsibility of the member states. In Germany, consumers who feel discriminated against for the above reasons can contact the Federal Network Agency. The agency can impose penalties of up to €300,000 on companies. According to an initial evaluation study in 2020, the regulation has **improved cross-border access to goods and services** (European Commission, 2020b).

Introduction of a "28th regime" in company law

194. To **overcome trade barriers** resulting from different legal systems in the 27 EU member states and national divergences in the implementation of EU directives, the European Commission proposes the **introduction** of a so-called **28th regime as part of a "European Code of Business Law"**. ↘ BACKGROUND INFO 11 Such a regime would exist in addition to national legislation and not replace it, therefore representing a pragmatic alternative to complete harmonization.

↘ BACKGROUND INFO 11

Background: 28th regime in company law

The idea of a 28th regime is taken up in the Letta Report on the future of the single market (Letta, 2024). The **Uniform Commercial Code** (UCC) is cited as **a model**, having contributed significantly to the US internal market reaching a critical mass. The UCC is limited to commercial law in the US states and provides a consistent legal basis for the sale of goods, including contract conclusion and liability, as well as related credit transactions and the realisation of collateral in the event of default. According to the Letta report, another **positive example** that could serve as a model for the design of the 28th regime is **the Organisation for the Harmonisation of Business Law in Africa** (OHADA). The organisation comprises 17 predominantly French-speaking nations. It was founded in 1993 with the aim of creating a common commercial law to improve legal certainty and enforcement, particularly in cross-border economic activity in the member states. OHADA enacts so-called uniform laws, which are similar to EU regulations and are directly legally binding in all member states (Grünewald, 2025). **Within the EU** itself, there are already **examples of efforts similar to a 28th regime**, in that they supplement national frameworks through voluntary EU-wide regulations. For example, the European Patent Office's unitary patent offers the possibility of obtaining patent protection in 18 member states with a single application. Similarly, the Societas Europaea (SE) already provides an EU-wide corporate legal form for public limited companies. However, attempts to introduce a similar corporate form for small and medium-sized enterprises ("European GmbH") have failed due to differing views among member states.

195. A 28th regime would give companies the option of operating within a uniform regulatory framework and enable them to expand their cross-border activities in other EU countries more smoothly and with legal certainty (Aghion et al., 2025). Thomadakis and Marcus (2025) propose a 28th regime that includes the following aspects: An **EU-wide company form** should **enable fast**, **fully digital start-ups**, particularly for innovative start-ups, increase cross-border mobility and reduce administrative burdens through uniform reporting requirements. The rules of a 28th regime could also include **standardised templates for employment**

contracts, **remote work arrangements**, **stock option plans and employee secondments**. Regulations on hybrid or remote working arrangements can be seen as a substitute for physical labour mobility and can lead to a more efficient allocation of labour as a factor of production. Although there are no formal barriers to the free movement of people, labour mobility in the EU is lower than in the US (Head and Mayer, 2021). A **uniform insolvency law** as a further aspect of the regime would **simplify** the **pricing of risks across borders** and stimulate investment. Ultimately, such a regime also offers the opportunity to reduce the barriers to cross-border trade in the EU associated with differences in national tax systems through a **digital tax return template with uniform definitions and simplified compliance procedures**.

196. The European Parliament's Committee on Legal Affairs has launched an initial approach to implementing a 28th regime with a new legal framework for innovative companies (Repasi, 2025). The aim of this legal form, known as the **European Start-up and Scale-up Company (ESSU)**, is to overcome regulatory diversity within the EU and facilitate cross-border financing and mobility for small and medium-sized companies, start-ups and scale-ups. However, this ESSU is not intended to be an autonomous pan-European legal form. Instead, the proposal provides for member states to convert existing national company forms or create a new one. **Key features** include the **complete digitisation of the formation and registration procedures**, **which should be completed within 48 hours**. In addition, the ESSU aims to improve access to capital and skilled labour, for example by harmonising rules on **equity-like debt instruments and optional employee share ownership plans** (ESOPs). Finally, the introduction of specialised **dispute resolution mechanisms** is envisaged, including specialised chambers at national courts, which would also offer proceedings in English.

197. A **28th regime could reduce trade barriers in the internal market that are attributable to differing national regulations**. Small and medium-sized companies in particular, including start-ups, could be established more easily and smoothly, obtain financing and commence business activities across Europe if there were uniform rules for start-ups, liability, insolvency and, ideally, labour and tax law. However, past experience has shown that, particularly in the areas of labour and tax law, harmonisation efforts have failed due to differing views among member states and concerns about potential disadvantages compared to the status quo. Member states have different national institutions and preferences in these areas, for example with regard to employee protection rights and co-determination. This is illustrated, for example, by the opt-out clause in the Working Time Directive or the failure of the Commission's proposal for a common consolidated corporate tax base. In order not to squander the opportunity for significant improvements in access to the internal market through a 28th regime, efforts to establish a uniform legal form and its founding modalities, as well as insolvency law, could be prioritised initially, as these appear to be more politically feasible. Alternatively, the 28th regime could also be broadened in terms of its scope, but only be open to a certain type of company, such as those that invest heavily in R&D or hold intellectual property (Draghi, 2024b).

2. Strengthening the capital market

198. **Well-developed and liquid capital markets promote long-term growth** by accelerating productivity growth through the reallocation of capital and enabling the financing of innovative companies (GCEE Annual Report 2023 box 13). Integrated capital markets also help to diversify risk and expand the financing options available to all companies. The first attempt to create a Capital Markets Union (CMU) began in 2015 with the action plan of the European Commission. In 2020, the Commission presented another action plan containing new initiatives. However, progress on the CMU has so far been limited to individual areas. For example, progress has been made in simplifying withholding tax refunds, but overall implementation remains slow (Arampatzi et al., 2025).

199. In 2025, the European Commission presented a new strategy for a **Savings and Investment Union** (SIU) (European Commission, 2025c). The Savings and Investment Union is intended to build on the initiatives launched under the CMU and the measures to develop the banking union. In addition, as recommended in the Letta and Noyer reports, it focuses on developing higher-yield savings and investment products for the long-term financing of capital formation. As a first step, the European Commission has presented recommendations for establishing simple and transparent savings and investment accounts (European Commission, 2025d).

Expansion of venture capital financing

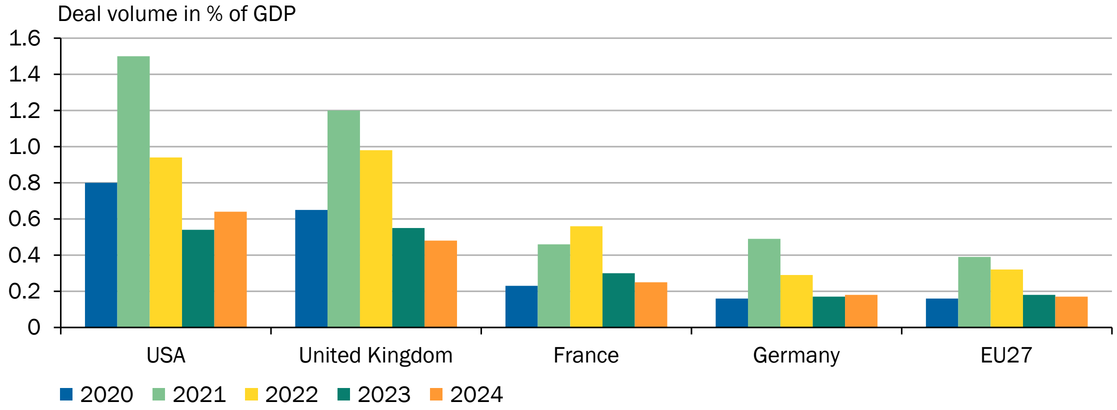
200. **Venture capital** is **central to innovation and economic growth**. By financing start-ups and scale-ups, it contributes to the development and commercialisation of future technologies. Venture capital plays a crucial role in the early and growth phases of young companies, when there is great uncertainty about future success. Although venture capital financing in the EU has increased significantly in recent years, it remains well below the level in the United States. In the EU, venture capital financing averaged 0.24 % of GDP from 2020 to 2024, while in the United States it reached 0.88 % of GDP. ↘ CHART 49 Europe lags behind particularly in the later stages of financing and in terms of large volumes (Fratto et al., 2024; Viete and Oschwald, 2025).

The **global venture capital market** is **dominated** by **large US funds**. Only 5 % of the capital raised by venture capital funds worldwide comes from the EU, while 52 % comes from the US (Fratto et al., 2024). The involvement of foreign venture capitalists increases the risk of companies relocating abroad, and this effect can be demonstrated particularly clearly in the case of the US (Hellmann and Thiele, 2023; Weik et al., 2024). In addition, the start-up ecosystem plays a role in start-ups' location decisions (Ferrary and Granovetter, 2009; Sariri, 2025). In this respect, too, the EU is at a disadvantage compared to the US. The exodus of innovative start-ups can reduce growth in the EU and its technological sovereignty.

201. Market failure can occur when it comes to financing young, innovative companies. Private investors often avoid particularly risky investment projects. In addition,

↘ CHART 49

Significant differences in venture capital investments in international comparison



Source: Viete and Metzger (2025)
© Sachverständigenrat | 25-240-01

the market is characterised by information asymmetries between founders and investors. In order to further develop the venture capital market and provide additional financing, **public co-investments** that mobilise private capital can be useful. Public funds can attract a broader investor base both through the direct provision of capital and in their role as an anchor (Kraemer-Eis et al., 2023). This allows private actors to gain experience and build expertise, which improves the returns on their funds (Giot et al., 2014). This approach in attracting new investors is being pursued by the Growth Fund ("Wachstumsfonds") Germany and Plan Tibi in France. These national initiatives have stimulated local ecosystems, but not comprehensively stimulated the pan-European venture capital market (Böninghausen et al., 2025). To **strengthen the pan-European venture capital market**, European initiatives such as the European Investment Fund (EIF) and the European Tech Champions Initiative (ETCI) can pool resources ↘ BACKGROUND INFO 12 and support scale-ups in line with the EU's innovation and growth objectives (Arnold et al., 2024).

↘ BACKGROUND INFO 12

Background: Venture capital market initiatives in the EU

There are several initiatives in Europe to strengthen the venture capital market. The **European Investment Fund (EIF)** plays a central role in this. As part of the European Investment Bank Group (EIB Group), it supports venture capital funds, provides guarantees and directs funds specifically to start-ups and small and medium-sized companies. The EIF is a public-private partnership whose largest shareholder is the European Investment Bank (EIB). Other shareholders include the European Union and financial institutions from EU member states and Turkey. All EU member states are also shareholders in the EIB. In addition, the **European Tech Champions Initiative (ETCI)** was launched in 2023 by the EIB Group together with five member states. It was designed as a fund of funds that invests in large venture capital funds. The aim is to ensure that European start-ups have sufficient capital at their disposal in later growth phases. Both the EIF and the ETCI pursue the overarching goal of strengthening the competitiveness of the European innovation ecosystem, attracting private investors and reducing dependence on non-European sources of capital. Another instrument is the **European Innovation Council (EIC)**, which was established as part of the EU's Horizon Europe research programme. The EIC Board, which includes researchers, companies and investors, is responsible for its strategic direction and implementation. With a budget of €10.1 billion, the EIC aims to promote disruptive innovation. Through the EIC Fund, it invests as a venture capital component in the early growth phase of European start-ups.

202. Many of the initiatives in the EU to date have aimed at strengthening financing in the early and growth phases. In the coming years, it will be crucial for investors to be able to sell their shares at a profit ("exits"). A **common pan-European stock exchange** could make IPOs in Europe more attractive as an exit option, as it would lead to greater integration and deeper and more liquid stock markets.

203. The secondary market, which involves the purchase and sale of existing holdings, is playing an increasingly important, albeit still small, role in the United States. A secondary market can increase the liquidity stakes in venture capital funds and reduce the risk of being tied to an investment for years. For start-ups, it offers the advantage of remaining private for longer if the market environment is unfavourable, for example for an initial public offering (IPO). The creation of a **pan-European secondary market** for technology companies prior to their IPO would enable investors to sell their stake before a public listing. By improving exit options for investors, such a market could make investment in European start-ups and scale-ups more attractive overall, give founders better access to financing and thus reduce incentives to leave the EU (Aghion et al., 2025).

204. Measures to develop the venture capital market should go hand in hand with efforts **to improve growth opportunities for companies as a whole**. These include establishing a 28th regime for innovative companies, ↘ ITEM 196 removing trade barriers in the internal market, ↘ ITEM 175 such as national regulations like reporting requirements or necessary approvals ↘ ITEM 177 and, in general, further developing capital markets, such as establishing pension funds and strengthening the equity culture (GCEE Annual Report 2023 item 193). However, Draghi (2024a) emphasises that inconsistent and overly restrictive regulations, for example in the field of artificial intelligence, are hampering the growth opportunities of companies in the EU.

Reform of capital market supervision

205. In order to strengthen the integration of EU capital markets and overcome the fragmentation of supervision, the **reform of the European Securities and Markets Authority** (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA) is of great importance. The regulatory fragmentation of authorities along national borders is a major obstacle to the integration of EU capital markets (FGCEE, 2024).

206. A proposal by Véron (2025) envisages a **newly established ESMA that supervises all companies and activities in capital markets**. ESMA should be headed by a compact Executive Board with fewer than ten members, which would

have sole decision-making power for administrative and supervisory tasks. ESMA would be financed mainly through levies on supervised companies, supplemented by EU budget funds for non-supervisory activities such as the development of technical standards. A decentralised organisational concept with several ESMA locations would increase proximity to the market and also allay concerns about the possible preferential treatment of certain financial centres.

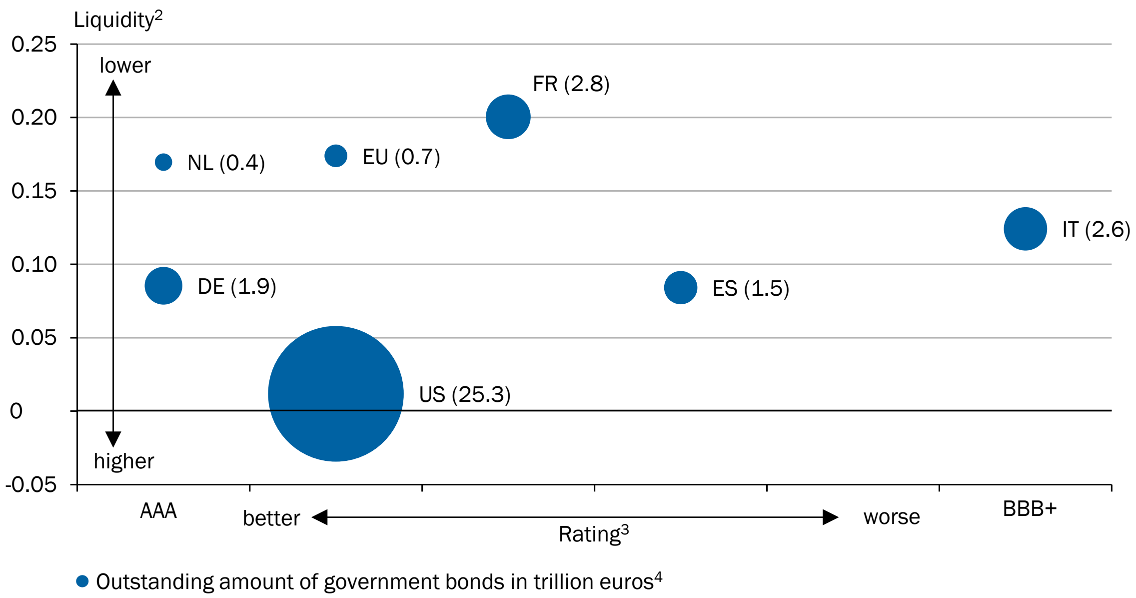
Establish a European safe asset

207. Almost all financial market players are looking for safe assets. **Safe assets are characterised by stable nominal returns, high liquidity and very low credit risk**. They play a particularly important role in times of crisis, as they retain their nominal value while the value of other assets tends to fall (Habib et al., 2020). They are also suitable for securing financial transactions, such as repurchase agreements (repos). Regulatory requirements also require some financial market participants to hold safe assets so that they can overcome stress situations, such as the outflow of bank deposits. The largest market for safe assets is the US Treasury market, followed by the market for German government bonds (Blanchard and Ubide, 2025). ↘ CHART 50 In Europe, during the euro crisis, it became apparent that French government bonds, for example, were no longer considered a substitute for German bonds, which highlights the status of German government bonds as a regional safe haven (Nenova, 2025).

208. Currently, the euro area lacks a deep, liquid and integrated market for risk-free bonds. The fragmentation of European government bond markets reduces market

↘ CHART 50

Indicators for credit risk and liquidity in selected countries[1]



1 – DE-Germany, ES-Spain, EU-European Union, FR-France, IT-Italy, NL-Netherlands, US-USA. 2 – Measured as the average bid-ask spread in September 2025 in basis points. 3 – Minimum rating from ratings of S&P, Fitch, Moody's, Scope as of 22 October 2025. 4 – Value for the USA converted using the ECB exchange rate on 1 October 2025.

Sources: BIS, ECB, European Commission, Fitch, LSEG Workspace, Moody's, national finance agencies, Scope, Securities Industry and Financial Markets Association, own calculations liquidity (Smaghi, 2025) and stability (Mosk and de Vette, 2025). The establishment of a **European Safe Asset** (ESA) could **reduce** the **fragmentation of European government bond markets by** serving as a common reference asset. An ESA could fulfil the function of a reliable store of value and serve as collateral and a price benchmark for financial transactions, as well as meeting regulatory requirements (Gourinchas and Jeanne, 2012). A liquid ESA would also offer institutional investors such as insurance companies and pension funds a reliable investment instrument (ESRB, 2018). At the same time, ESAs can play a stabilising role in times of crisis when investors flee to safe investments. A possible flight to ESAs would occur across asset classes and not across national borders into the bonds of some European countries that are considered safer (ESRB, 2018). Capital flows from peripheral member states to core countries led to additional destabilising effects during the European banking and sovereign debt crisis (García and Gimeno, 2014).

In addition, an ESA could **mitigate** so-called **"doom loops"** between countries and banks, which occurred during the European banking and sovereign debt crisis (Bletzinger et al., 2023). In a "doom loop", countries find themselves in financial distress, causing their bonds to lose value, as was the case in Greece in 2010. If domestic banks hold these bonds on their balance sheets, these banks are weakened. Banks in Europe are currently not required to hold equity as a risk provision for European government bonds held in domestic currency. If these banks then have to be supported by the state, this in turn worsens public finances and the downward spiral continues. However, the shock can also originate from banks, as was the case in Ireland in 2011, and then affect public finances as concerns about financial stability grow (Farhi and Tirole, 2018).

209. **Proposals for the implementation of an ESA** can be divided into **three categories**: **synthetic safe bonds** constructed from senior tranches of pooled government bonds (Brunnermeier et al., 2011, 2016), **Eurobonds issued jointly** by all member states (Delpha and von Weizsäcker, 2010; Blanchard and Ubide, 2025) and the **issuance of debt instruments by EU institutions** (Ubide, 2015). These proposals differ in the extent of joint liability and the necessary changes to EU legislation.

210. The first category is based on a proposal by Brunnermeier et al. (2011, 2016) and envisages a European debt agency or private issuer **purchasing**, **pooling and tranching member states' government bonds according to fixed weights**. The weights remain constant and cannot be adjusted to support distressed countries. The debt agency issues securities with a senior tranche (European Safe Bond or "ESBie") and a junior tranche (European Junior Bonds, "EJBie"). The ESBies are serviced first from the repayments of the government bonds in the portfolio, while the EJBies are serviced subordinately from the remaining payments. In the event of a default, the EJBies would thus be called upon to a certain percentage, while payments for the ESBies would continue to be made. With ESBies and EJBies, there is no joint liability, i.e. individual member states remain responsible for their own bond issuance and servicing. To ensure that banks hold secure ESBies and not EJBies, EJBies should be given a risk weight in

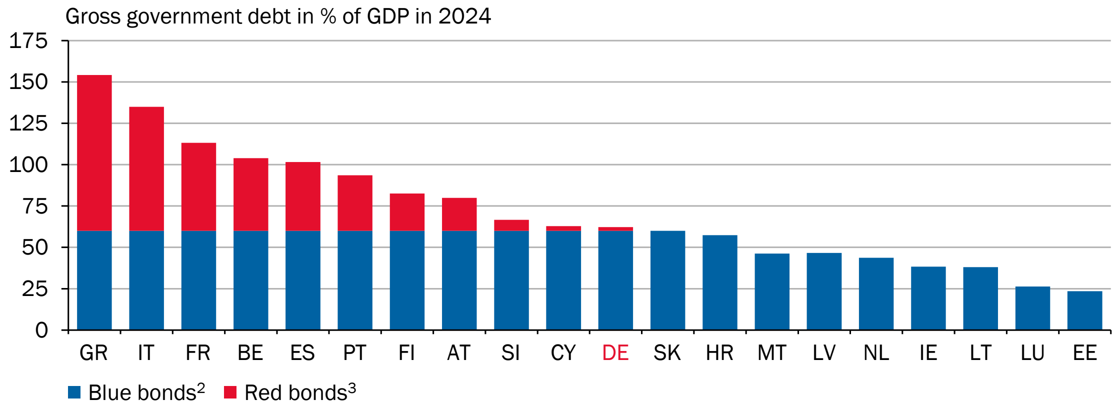
line with their default probability. This would require banks to hold equity for possible defaults.

With a split of 70 % for ESBies and 30 % for EJBies, Brunnermeier et al. (2016) simulate an **expected loss rate** for **ESBies** of 0.09 % in the baseline scenario and 0.42 % in a crisis. In both cases, the rate would be **below the rate for German government bonds**. ESBies would therefore be suitable for meeting regulatory requirements for liquidity reserves. A key advantage of ESBies would be that the creation would increase the volume of available safe assets. They could also make it easier for other market participants to hold a more diversified portfolio of government bonds (Cochrane et al., 2025). However, it is unclear whether there is sufficient demand for EJBies in the market, given the higher risk (Zettelmeyer and Leandro, 2018; Monteiro, 2023). Furthermore, buying up and bundling bonds in ESBies and EJBies could drain liquidity from the bond markets of smaller countries with lower debt levels if this resulted in fewer bonds remaining on the market. In large countries with high debt levels, on the other hand, this could lead to the portion not purchased being regarded as high-risk bonds in times of crisis (Minenna, 2017).

211. The second category, **Eurobonds**, involves **joint liability for** part **of the outstanding debt of euro area member states**. Delpla and von Weizsäcker (2010) propose dividing national debt into so-called blue bonds and red bonds. Blue bonds could account for up to 60 % of national GDP, in line with the debt limit permitted under the Maastricht criteria. ↘ CHART 51 All euro area member states would be jointly liable for these blue bonds. These bonds would be serviced on a priority basis in the event of a crisis. Red bonds would continue to be issued individually by each country and would be serviced on a subordinated basis. Assuming that spreads only reflect the default risk of the original sovereign debt, this would mean that senior blue bonds would have a lower interest rate and national bonds would have a higher interest rate. Average financing costs would remain unchanged (Blanchard and Ubide, 2025). Higher interest rates for red bonds could strengthen fiscal discipline, as the marginal costs of additional borrowing would increase. This idea of Eurobonds was further developed by Blanchard and Ubide (2025). They propose a lower limit of 25 % of GDP for blue bonds, which they estimate is a sufficiently large amount to provide adequate liquidity while ensuring the sustainability of the joint debt. Their proposal envisages the EU purchasing existing bonds and issuing blue bonds for the same amount. Delpha and von Weizsäcker (2010), on the other hand, proposed establishing an Independent Stability Council (ISC) to determine the allocation of blue bond quotas by country.

212. A key question in the division between blue and red bonds is whether EU member states would be **credible** in their **willingness to default on** their **subordinated bonds in the event of a crisis**. This is the only way to effectively secure the creditworthiness of jointly issued blue bonds. To this end, the institution issuing the blue bonds could be granted the status of a senior creditor (Monteiro, 2023). member states could commit to using a certain portion of their tax revenue, such as value-added tax, to pay interest on the blue bonds and enshrine this in law. Alternatively, an increase in contributions to the EU budget could be used to service the interest payments (Blanchard and Ubide, 2025). If bond yields

↘ CHART 51
Breakdown of the government debt-to-GDP ratio in Blue and Red bonds in the member states of the euro area in 2024[1]



1 – GR-Greece, IT-Italy, FR-France, BE-Belgium, ES-Spain, PT-Portugal, FI-Finland, AT-Austria, SI-Slovenia, CY-Cyprus, DE-Germany, SK-Slovakia, HR-Croatia, MT-Malta, LV-Latvia, NL-Netherlands, IE-Ireland, LT-Lithuania, LU-Luxembourg, EE-Estonia. 2 – Debt up to the Maastricht debt ratio of 60 % with secured, jointly liable government bonds. 3 – Debt exceeding the Maastricht debt ratio with national, subordinated government bonds.

Sources: Eurostat, own calculations

averaged between 2 % and 4 %, servicing the blue bond debt under this proposal would require earmarked tax revenue of around 0.5 % to 1 % of GDP (Lane, 2025).

213. **Reservations** about Eurobonds mainly stem from the risks that could arise from **joint liability**. In the case of joint liability, individual member states might have less incentive to consolidate their budgets. This could lead to economically stronger member states co-financing the debts of weaker member states by paying higher interest rates. At the same time, highly indebted countries could be incentivised to increase their debt levels. Overall, there is a risk that joint liability could create false incentives for excessive borrowing, thereby negatively impacting fiscal sustainability in the EU. In addition, depending on the design of the debt instrument, an amendment to the European Treaties would be necessary. According to the "no bail-out clause" (Article 125 TFEU), the Union and member states are not liable for the obligations of another Member State and do not assume responsibility for them (Deutscher Bundestag, 2015).

214. The third category comprises **bonds issued by European supranational issuers** such as the EIB, the EU, the European Financial Stability Facility and the European Stability Mechanism (ESM). EU bonds are widely considered safe, and the cost of hedging against default remained stable during the coronavirus pandemic (Bletzinger et al., 2023). Measured by the bid-ask spread, the market liquidity of EU bonds such as NGEU or SURE (Support to mitigate Unemployment Risks in an Emergency) was lower than that of large EU member states such as Germany or Spain before 2020. The bid-ask spread has improved over time as more bonds have been issued, but it remains higher than for other European government bonds (Bletzinger et al., 2023). In order to function as a European safe asset and ensure sufficient liquidity, the EU would have to issue such bonds on a regular basis. However, EU bonds are not considered by the market to be equivalent to government bonds. The European Commission is currently treated as a

supranational entity by the major index providers such as MSCI and Intercontinental Exchange (ICE) and has therefore not been included in the government bond index (Ritchie, 2025).

215. The implementation of ESBies offers clear advantages. It does not require any amendment to the European treaties and, due to the lack of joint liability, it should be easier to implement politically. It could solve the problem of the "doom loop". Whether ESBies meet the requirements for a safe asset and can provide sufficient stability in times of crisis remains to be seen. The alternative would be **risk sharing with (partial) joint liability** of EU member states for EU bonds, **which** would require **new sources of revenue** at European Union level **or a permanent redistribution of national fiscal space** to the European level (fiscal union). In this respect, ESBies represent a partial technical solution as long as the fundamental problem of a lack of fiscal union in a monetary union remains unresolved.

216. In order to create the **conditions** for **joint bond issuance**, for example to meet pent-up demand in defence, ↘ ITEM 249 a well-designed **mechanism is needed to deal with crises and payment difficulties** of states, given the already high debt burden in some European member states. ↘ ITEM 243 Cochrane et al. (2025) propose further developing the ESM or creating a new European fiscal institution. This institution would provide temporary fiscal support to countries while they implement reforms to ensure their fiscal sustainability. In order to raise the necessary funds, the newly created fiscal institution could issue "Eurobonds". These Eurobonds could be accompanied by joint liability of the member states or liability of the EU with EU tax sovereignty. In addition, a uniform restructuring mechanism would enable the orderly and transparent restructuring of sovereign debt.

217. **Joint debt financing by the EU**, such as NGEU, poses **challenges** in terms of **targeted use** for productive purposes and transparency. Although on average 80 % of NGEU funds were spent on additional projects, some member states, such as Italy and Cyprus, have substituted already planned expenditure (Bańkowski et al., 2024). This increases the risk that higher taxes will be necessary in the long term without generating corresponding economic returns (Benigno and Edoardo, 2025). The necessary institutional arrangements for joint debt are therefore clear and enforceable liability and accountability mechanisms, as well as credible monitoring and sanctions that provide ex ante incentives to avoid fiscal sustainability risks.

3. Conclusion: Internal market

218. The **European single market** should be **further completed**. Numerous barriers continue to hamper cross-border trade. ↘ ITEM 175 This reduces sales markets, prevents **efficient division of labour and allocation of resources**, and reduces **productivity** (Adilbish et al., 2025). Some of these problems have been known for years, but so far it has not been possible to reduce trade barriers. The European Commission has taken a step in this direction with its "Terrible Ten". In order to make progress in deepening the internal market, concrete proposals

for measures that need to be prioritised are required. One of the European Commission's concrete proposals is **to remove territorial supply restrictions** in order to strengthen competition and reduce prices. Another is the **introduction of a 28th regime in company law**. By making it easier to set up and run a company across national borders, young, innovative companies with new technologies in particular can benefit from the size of the internal market. ↘ ITEMS 194 FF.

219. A 28th regime would have the potential to stimulate cross-border investment in the EU by increasing comparability between companies. In particular, it could make it easier for start-ups to raise capital across borders. ↘ ITEM 196 These companies lack venture capital financing, especially in the late stages. The fragmented and bank-based capital market also offers fewer exit opportunities. In order to further develop the venture capital market, **resources for European venture capital financing initiatives** should **be pooled**. This increases the chance of being able to meet the larger financing needs of scale-ups.

220. The completion of the single market forms the basis for facilitating cross-border financing through appropriate measures such as a 28th regime. Such greater **integration of financial markets** can reduce the cost of capital for companies. However, it **does not automatically** lead to **more** large-scale **investment activity** by companies. It is, however, a necessary prerequisite.

221. Furthermore, **integrating capital market supervision** by establishing ESMA as an independent and central supervision authority can reduce market fragmentation. ↘ ITEM 206 In order to overcome the fragmentation of European government bond markets and create a deep and liquid market for risk-free assets, a **European Safe Asset** (ESA) could be created. This would serve as collateral, a price benchmark and a stabilising instrument in times of crisis. ↘ ITEM 207 In addition, this could strengthen the attractiveness of the euro as an international reserve currency. Since **establishing ESBies** does not require any amendment to the European Treaties and does not provide for joint liability, this proposal could be easier to implement than Eurobonds in order **to create an ESA with high liquidity and creditworthiness**. However, a long-term solution that makes the euro system more crisis-proof requires a reform of the fiscal architecture. ↘ ITEM 210

IV. STRENGTHENING DEFENCE CAPABILITIES TOGETHER

222. European defence capability is a public good whose benefits extend beyond national borders. As a result, individual member states may underinvest because they do not internalise the positive externalities for other countries (Beetsma et al., 2024). In addition, national procurement decisions often pursue national industrial policy objectives (Fuest and Pisani-Ferry, 2019) and therefore do not optimise defence capabilities. Procurement is often not coordinated at European level, which makes joint defence technically difficult and prevents EU member states from benefiting from economies of scale. European coordination can help to strengthen European defence capabilities. Three areas of action are key to this. First, **procurement** should be made **efficient and resilient** by using joint European procurement processes to overcome the fragmentation of the internal defence market and realise economies of scale. ↘ ITEMS 229 FF. Second, **innovation in the defence sector** must **be promoted** in order to reduce Europe's technological lag behind its global competitors. ↘ ITEMS 239 FF. Third, there should be opportunities for joint **financing**, as the provision of European security is considered a European public good. ↘ ITEMS 243 FF.

1. Making procurement efficient and resilient

223. Many **EU member states have shortfalls** in **military equipment**. Wolff et al. (2025) see this shortfall particularly in battle tank stocks, artillery systems, ammunition, drones and aircraft. In addition, they highlight the **need for so-called strategic enablers**, i.e. resources and structures that enable military cooperation and functionality between several states and cannot easily be provided at the national level alone. These include satellite-based intelligence and communication, the development of modern weapon systems such as the latest generation of fighter jets, strategic air defence systems such as Patriot or SAMP/T (Sol-Air Moyenne-Portée/Terrestre) batteries, rocket artillery similar to the US HIMARS (High-Mobility Artillery Rocket System), and transport capacities such as heavy transport helicopters of the type Chinook. The European Commission (2025a) also points to a need to catch up in other areas, particularly in **key technologies** such as **artificial intelligence**, **quantum computing**, **and cyber and electronic warfare**. These are indispensable for securing the electromagnetic spectrum, protecting critical infrastructure, and expanding offensive and defensive cyber capabilities.

224. In order to address the need to catch up as efficiently as possible, a first step would be to increase competition in the EU. Despite existing European regulations, **many contracts for defence equipment continue to** be **awarded without EU-wide competitive tendering procedures**. Although an EU directive lays down common rules for the procurement of weapons, ammunition and war material (European Parliament and Council of the EU, 2009), member states very rarely apply them, especially when awarding contracts for complex defence

systems (European Commission, 2016). This is likely due to a broad interpretation of possible exceptions in the directive and exceptions under Article 346 TFEU, ↘ BOX 11, which allow member states to award defence contracts outside the EU procurement rules (European Commission, 2016). **Stronger application of existing EU rules in the defence sector** would strengthen the European single market for defence equipment and promote competition between European companies in the defence sector. As a first step, the European Commission could strengthen its monitoring of the uniform implementation of European requirements.

225. The **delivery of defence equipment to third countries is subject to National export controls** applied in EU member states. These controls are intended in particular to prevent the proliferation of weapons of mass destruction and the destabilising accumulation of conventional arms in crisis regions (BAFA, 2024). However, these export controls vary greatly between individual EU member states (Mölling and Schütz, 2019). Although there are **common criteria for arms exports at the EU level**, such as compliance with international obligations, respect for human rights and the preservation of peace, security and stability (bpb, 2011). However, the **implementation and enforcement** of the restrictions is **left to the member states** (Council of the EU, 2008). The European Commission and the European Court of Justice have no powers to enforce EU criteria for export controls on defence equipment. In addition, national export controls pursue strategic foreign and security policy objectives, which makes uniform application difficult (Sabatino, 2024).

226. At the same time, the **defence industry** is **dependent** on **cross-border supply chains** (Clapp et al., 2025). Although the existing EU-wide licensing of military components facilitates their transfer within the EU, ↘ BOX 11 **different national control regimes for military goods** and different interpretations of European requirements create **uncertainty for producers when exporting to third countries**. If, for example, the export of a key component of a weapon system is denied by one Member State within an EU supply chain, this can block the export of the entire defence equipment from the EU to third countries (Clapp et al., 2025). Support for Ukraine with military goods has intensified the discussion on export controls for military goods in the EU (Sabatino, 2024).

In this sense, **greater harmonisation of legal practice in export control at EU level** can reduce uncertainty about export opportunities for the defence industry and thus promote cross-border cooperation within the Western alliance. Unlike purely military goods, there is already a harmonised control regime for the export of **dual-use goods** ↘ GLOSSARY at EU level (European Parliament and Council of the EU, 2021), which is applied uniformly. This could serve as a model for creating a **uniform EU-wide regulatory framework** for military equipment as well. The latter would likely require an amendment to the European treaties. However, this faces political obstacles, as export practices are closely linked to national foreign, security and economic policy interests (Sabatino, 2024).

227. When **exporting defence equipment to third countries in the Western alliance**, **the** following **potential trade-off** must be evaluated. On the one

hand, exports between EU member states and third countries in the Western alliance should in principle be possible in order to promote cooperation between companies and the development and production of competitive key technologies, thereby strengthening the EU's own defence capabilities. ↘ ITEM 237 On the other hand, international law and ethical principles ↘ ITEM 225 should not be compromised in the case of exports. This trade-off must be assessed politically.

228. The **procurement of defence equipment in the EU** has **so far** been strongly influenced by a **preference for national suppliers**. Between 2005 and 2022, around 29 % of defence spending went to national producers, 33 % to suppliers from other member states and 37 % to third countries (Centrone and Fernandes, 2024). In Germany and France, the national share was even higher, at over 80 %. This fragmented procurement leads to small order quantities, which make cost-efficient production difficult. In addition, there are a multitude of different national standards, which significantly limit the interoperability of weapon systems (Wolff et al., 2025). Since the start of Russia's war of aggression, the share of arms procurement from third-country suppliers has increased significantly. Between February 2022 and July 2023, 78 % of these procurements took place outside the EU, mainly from the USA (European Commission, 2024). This indicates a prioritisation of US suppliers. In particular, however, there is a dependence on US suppliers in the areas of missiles, artillery ammunition, fighter jets and strategic air defence systems (Irto et al., 2025; Mejino-López and Wolff, 2025).

229. The **monopoly-like market structure** that prevails in most **national defence equipment markets** leads to an oligopolistic market structure at the European level. It would therefore be helpful for member states to pool their purchasing power. **European-coordinated procurement and pooling of demand** would significantly improve the negotiating position of the ordering states vis-à-vis the defence industry. This would allow lower prices and larger quantities to be negotiated. At the same time, there should be a stronger focus on European suppliers, ideally with uniform standards for weapons system providers. This would increase the resilience of European defence capabilities, enable economies of scale and contribute to the harmonisation of technical standards.

230. To **promote joint procurement**, the EU has already launched several, in some cases parallel, temporary measures. ↘ BACKGROUND INFO 13 In addition, the EU could **create** a **permanent institution** with the **European Defence Mechanism (EDM)**, which, similar to the European Stability Mechanism, would be based on an intergovernmental treaty (Wolff et al., 2025). The EDM could manage the pooling of demand and the coordination of joint procurement processes. This would ensure central military capabilities and their joint use at the European level. The advantage of a legally independent entity at European level for the procurement of military equipment would also be that countries outside the EU could participate on a case-by-case basis and more easily than in national cooperation.

↘ BACKGROUND INFO 13

Background: Temporary procurement measures by the EU

The **European Defence Agency (EDA)** was founded in 2004 and has since been supporting EU member states in developing their **defence capabilities** and **military cooperation.** Its core tasks include identifying common capability requirements and priorities at EU level, promoting joint research, technology and innovation projects in the field of defence, harmonising requirements and developing capabilities jointly. Since 2024, its core tasks have also included **pooling demand through joint procurement** and coordination with EU civil and defence policy areas (EDA, 2024). While the Act in Support of Ammunition Production (ASAP) initiated the targeted expansion of ammunition production in the years 2023 to 2025, the European Defence Industry Reinforcement through Common Procurement Act (EDIRPA) established an instrument to promote joint procurement for the years 2024 to 2025. However, both were merely short-term emergency measures. Under EDIRPA, for example, procurement projects were initiated for 155 mm artillery ammunition for Ukraine, for air and missile defence systems, for modern armoured vehicles and for additional ammunition stocks (European Commission, 2025e). Despite the EDA's role in negotiating and centralising procurement contracts, member states retain decision-making authority over which goods to be procured and from which defence companies to order from (Caranta, 2023).

In order to create a **regulatory framework** after the expiry of EDIRPA and ASAP, the **European Defence Industry Programme (EDIP)** was established for the years 2025 to 2027. It is intended to implement the measures identified in the **European Defence Industrial Strategy (EDIS)** and provides for a new legal instrument that, with the **Structure for European Armament Programme (SEAP)**, establishes a **permanent framework for joint procurement** for the first time.

231. The **structural challenges in European procurement** can be illustrated using the German system as an example. **In Germany**, there are **three different procurement procedures** available. The Einkauf der Bundeswehr (EinkaufBw) for commercially available and Bundeswehr-specific material, a procedure for complex services, and the projektbezogene Bedarfsdeckung und Nutzung (PBN) for complex weapon systems (BMVg, 2024a). In 2024, PBN replaced the previously applicable Customer Product Management (CPM) system. The standard procedure for German PBN is divided into three phases: analysis, implementation and utilisation. There is a simplified procedure for requirements up to €500,000. In addition, the regulation defines special procedures for IT procurement, procurement of products that are to be developed (Entwicklungslösungen) and for urgent procurement (Sofortinitiative für den Einsatz). Procurement by the Bundeswehr is therefore rather sequential, as parts of the procurement process are outsourced from the PBN to the upstream planning process (Hunte, 2021). The draft of the Bundeswehrplanungs- und Beschaffungsbeschleunigungsgesetzes provides for the strengthening of innovative procurement approaches (Article 14 (1) BwPBBG). This can help to integrate the development and commissioning process more closely.

232. **In German procurement**, contracts with **a cost-price model** are often used for **orders** for which market prices cannot be established, such as large weapon

systems. This type of contract provides for the reimbursement of production costs plus a fixed profit margin. While this approach is intended to protect against excessive price mark-ups, cost increases can be passed on. ↘ ITEM 505 Since around half of public tenders for defence equipment are awarded on the basis of the "lowest price" criterion (Glas et al., 2025) and the underlying contract model allows cost increases to be passed on, initial costs are often deliberately set low (Brzoska, 2019). For example, the 19th Armaments Report of the Federal Ministry of Defence (BMVg) reported cost increases of around €14 billion and average delays of around 26 months compared to the first parliamentary debate (BMVg, 2024b). This contract model therefore does not create sufficient incentives for cost-efficient production or reliable adherence to deadlines (KPMG et al., 2014).

233. **Fixed-price contracts** could be used as an alternative, as they rule out subsequent price escalations. However, the example of the A400M transport aircraft shows the limitations of this approach. Although fixed prices were agreed in 2003, the manufacturer EADS revealed significant technical and financial difficulties in 2009 and threatened to abandon the project. This led to new negotiations, which resulted in significant price increases (Brzoska, 2019).

234. While traditional procurement approaches aim to achieve cost-effectiveness through detailed specifications and a high level of control, newer approaches, such as **performance-based logistics (PBL)**, pursue a **more strategically oriented goal**. The focus is not on the precisely specified product or service, but on the **desired result** (Glas et al., 2011). The concept of **performance-based contracting (PBC)** is used to create effective performance incentives (U.S. Department of Defence, 2016). This involves setting measurable standards for quality, time and quantity, and the contract model provides for sanctions in the event of non-fulfilment. This model not only creates scope for efficiency gains, but also for innovation and alternative value creation concepts. It also opens up opportunities for companies of different sizes to contribute their solutions to the procurement process.

In order to **make it easier for** innovative **start-ups** and small and medium-sized companies (**SMEs**) to **participate in competitive tendering procedures in the defence sector**, special tender formats could be created for these companies (Monopolies Commission, 2025). These procedures should be tailored to the needs and capabilities of these groups of companies and enable a rapid process.

2. Promoting innovation in the defence sector

235. **Modern weapon systems and key technologies** are **not yet** sufficiently available in Europe's national armed forces. This applies in particular to strategic enablers, where European defence currently relies heavily on NATO and US leadership (Wolff et al., 2025). The priority is therefore to acquire strategic enablers that should be placed under European operational control in the future. Joint procurement, for example of a satellite-based intelligence and communications

network managed within the framework of the EDM and made available to member states, would create shared benefits and improve sharing of the burden.

236. The recent conflicts in Ukraine and the Middle East illustrate that the **rapid development**, **adaptation and integration of new technologies**, in particular unmanned systems and artificial intelligence (AI), can be **crucial for modern warfare** (Andersin, 2025; Hakmeh, 2025; Pusztaszeri and Harding, 2025). In addition, the cost-effectiveness of new weapon systems in operational use is of great importance. Mejino-López and Wolff (2025) show, for example, that low-cost drone systems can quickly disable high-priced military equipment such as battle tanks.

237. The **USA**, **Israel** and **Ukraine** are characterised by their **rapid innovation and production cycles in key military technologies** (Gholz and Sapolsky, 2021; Luttwak and Shamir, 2023; Kirichenko, 2025). Cooperation with allied technology leaders can be of great importance in strengthening Europe's defence capabilities more quickly and generating synergy effects. Various current examples illustrate this. The Patriot air defence missile system, for example, represents a successful transatlantic cooperation between MDBA and RTX. US technology is manufactured in Europe (Siebold, 2025), which creates industrial resilience and manufacturing capacity. The Airbus-Kratos project combines a US platform with European mission systems (Airbus, 2025; Charpentreau, 2025) to manufacture a combat drone. This cooperation provides access to capabilities that have been tested in the US, even if a certain degree of technological dependence remains. German-Israeli cyber and security cooperation (BMI, 2025) promotes technology transfer with one of the world's leading players in cyber defence (Frei, 2020).

238. **Civilian innovations such as satellites**, **drones and AI are increasingly being used for military purposes**. Satellites are an essential basis for intelligence, navigation and communication. Drones have become a central means of warfare in Russia's war against Ukraine (Clapp, 2025b). AI-supported systems accelerate decision-making on the battlefield, increase the survivability of their users and multiply the speed of action and access to information for commanders (Burilkov et al., 2025). Against this backdrop, it appears strategically important for Europe to link civilian and military R&D in order to efficiently translate innovations into market-ready and operational systems.

239. In **Germany**, start-ups have recently made a significant contribution to the development of modern, particularly unmanned weapon systems. In view of this development, access to venture capital financing is of great importance. In 2024, the volume of venture capital financing for start-ups in the defence sector in the United States was about 2.4 times higher than in Europe (Chinn et al., 2025). For Europe to catch up in defence innovation, it is important **to provide funding for** the entire life cycle of **start-ups** and to **facilitate access to capital markets**. ↘ ITEMS 200 FF. The establishment of a European counterpart to the Defence Innovation Unit (DIU) in the United States could be helpful in this regard. The DIU supports the rapid integration of civilian technologies into the armed forces, accelerates the development and testing of dual-use goods, and provides direct access to venture capital and innovation networks. Initial steps in this direction

have already been taken at national level, for example in Germany. With the Cyber Innovation Hub, the Bundeswehr has had an interaction with start-ups since 2017 and has already launched 160 innovation projects. Of these, 19 have been made permanent, i.e. their technologies or products have been procured or introduced by the Bundeswehr.

240. Defence R&D spending in the EU is very low compared to the US. In 2023, 16 % of defence spending in the US went to R&D, compared to only 4.5 % in the EU in 2022. ↘ BOX 46 **Military R&D** can **promote innovation** and thus **strengthen economic growth beyond the defence sector** (Mowery, 2010). Investments in state-of-the-art defence technologies have higher economic multipliers than those in obsolete technologies (Enders et al., 2025). In addition, public investment in military R&D can stimulate private investment in this area, which is accompanied by **international spillover effects** (Moretti et al., 2025).

241. Complex next-generation defence systems require research investment that far exceeds the capacities of individual EU member states (Draghi, 2024b). This applies in particular to high-tech areas such as hypersonic weapons, unmanned systems and the military use of space. **Technological leaps**, such as those required for future defence systems, can be achieved **through combined European efforts** and focused funding of **joint R&D projects**.

A **centralised European counterpart to the Defence Advanced Research Projects Agency (DARPA)** could bring European resources together in a more targeted manner and achieve economies of scale. ↘ BOX 46 Various instruments for promoting R&D in the defence sector already exist at European level. The EDA coordinates research projects, while the European Defence Fund (EDF) has been providing financial support and promoting cross-border cooperation between defence companies since 2021. Since 2025, the European Investment Bank has also been able to finance projects whose primary purpose is defence. Against this backdrop, it seems sensible to examine whether greater centralisation and standardisation of funding instruments at European level could contribute to increased efficiency and impact.

242. Few European universities have close ties to defence ministries or the defence industry (Draghi, 2024b). **Cooperation between universities**, **research institutes**, **the defence industry**, **the military and the police** should be strengthened in the development of dual-use technologies. In doing so, existing institutional restrictions, such as civil clauses at universities that fundamentally exclude the military use of research (The Science4Peace Forum, 2025), must be critically examined. Less restrictive regulations could help to overcome divisions between civil and military research that inhibit innovation.

3. Joint financing

243. The security situation requires additional financial efforts to strengthen defence capabilities in Europe. However, the **fiscal space of EU member states varies**. Joint financing could thus solve a free-rider problem: national expenditure

may be too low because, in the event of a violation of EU territory, the member state with the relevant border is the first to be affected (Steinbach and Wolff, 2024).

At the same time, it should be noted that joint financing may create incentives for free riding, with individual member states minimising their contributions and relying instead on **financing** from others. If these funds are to be **provided jointly**, it must therefore be ensured that this does not create new risks for the **fiscal sustainability** of individual member states or the union as a whole. Otherwise, there is a risk that financial vulnerabilities will arise that could be exploited by adversaries in the event of conflict, thereby undermining Europe's resilience. A sustainable financing structure is therefore a prerequisite for the effectiveness of joint defence efforts.

244. **At European level**, the **ReArm Europe Plan** has been in place since 2025, aiming to **strengthen European defence capabilities** over the next five years. ↘ BACKGROUND INFO 14 The plan potentially involves an investment volume of up to €800 billion. A large part of this should be requested individually by each member state by activating the national escape clause of the Stability and Growth Pact. Currently, 16 member states have activated this exemption (Council of the EU, 2025b).

↘ BACKGROUND INFO 14

Background: ReArm Europe Plan

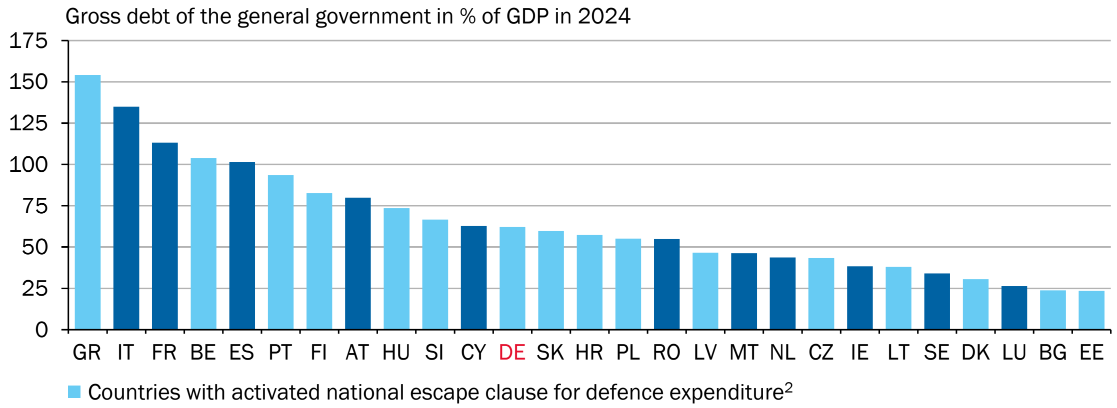
With the ReArm Europe Plan ("Readiness 2030"), the European Commission (2025a) has presented a **detailed strategy for strengthening European defence capabilities by 2030.** The strategy aims to strengthen Europe's strategic autonomy, reduce industrial fragmentation, increase the innovation and production capacity of the defence industry, and at the same time ensure support for Ukraine. To achieve this, the plan identifies key areas for action, such as closing critical capability gaps, ↘ ITEM 223 promoting an EU internal defence market, and preparing for military emergencies through improved military mobility, joint stockpiling, and operational cooperation.

The plan involves a **potential investment volume of up to €800 billion** and is based on **five pillars of financing.** Firstly, European member states have the option of requesting the activation of the national escape clause in the Stability and Growth Pact in order to create fiscal flexibility for an increase in defence spending. Second, Security Action for Europe (SAFE) is a new credit facility with a volume of up to €150 billion to finance joint procurement. Third, existing EU instruments, such as those under cohesion policy, are to be made more flexible for defence purposes. Fourth, the EIB Group intends to accelerate the provision of funds to strengthen Europe's security and defence capabilities with the EIB Group Security and Defence Industry Action Plan (EIB, 2024). Fifth, the aim is to mobilise private capital through the Savings and Investment Union.

245. The **ReArm Europe Plan** has **two** particular **weaknesses**. The funds raised through the national escape clause are spent nationally and without European

↘ CHART 52

Debt-to-GDP ratio of the EU27 member states[1] and the activation of the national escape clause of the Stability and Growth Pact



1 – GR-Greece, IT-Italy, FR-France, BE-Belgium, ES-Spain, PT-Portugal, FI-Finland, AT-Austria, HU-Hungary, SI-Slovenia, CY-Cyprus, DE-Germany, SK-Slovakia, HR-Croatia, PL-Poland, RO-Romania, LV-Latvia, MT-Malta, NL-Netherlands, CZ-Czechia, IE-Ireland, LT-Lithuania, SE-Sweden, DK-Denmark, LU-Luxembourg, BG-Bulgaria, EE-Estonia. 2 – On 8 July 2025, the European Council activated the national escape clause for: Belgium, Bulgaria, Croatia, Czechia, Denmark, Estonia, Finland, Greece, Hungary, Latvia, Lithuania, Poland, Portugal, Slovakia and Slovenia; and on 10 October 2025 for Germany.

Sources: European Council, Eurostat

coordination. However, uncoordinated procurement can be inefficient if different, incompatible systems are procured. Furthermore, only about half of the member states have made use of the exemption so far. ↘ CHART 52 This corresponds to additional defence spending of around €293 billion, or 45 % of the total volume that would be available if all member states applied for the exemption (de Lemos Peixoto et al., 2025). In some countries, the failure to apply is likely due to limited fiscal space for additional borrowing. In some member states, such as Italy and France, the debt burden is already high. In others, such as Spain and Austria, it is difficult to reach a political consensus on higher defence spending. The short-term option provided by the EU to finance additional defence spending through debt cannot therefore be exploited.

246. **Permanent expenditure on European defence** should be financed **from the regular budget**. The EU budget is based on a multiannual financial framework (MFF). In addition, an EU budget is adopted annually, which specifies the revenue and expenditure within the MFF. The current MFF for the years 2021 to 2027 corresponds to around 1.1 % of the EU's gross national income (GNI) (Deutsche Bundesbank, 2025). Agricultural expenditure and cohesion payments account for a large part of the MFF, at 32.5 % and 31.3 % respectively (Darvas and Mejino-López, 2024). Agricultural expenditure is intended to support farmers' incomes, while cohesion payments are intended to contribute to economic convergence within the EU. The MFF for the years 2028 to 2034 is set to rise to around 1.3 % of GNI (Pari and Pradier, 2025). However, the increase is to a large extent due to debt servicing for the NextGenerationEU (NGEU) recovery fund (Deutsche Bundesbank, 2025). According to an estimate by Lindner et al. (2025), funding for agricultural and cohesion policy would fall by around 15 % and 10 % respectively, while spending on security and defence would more than triple. In addition, the new financial framework is intended to allow for more flexible use of funds

within the areas of research, infrastructure and defence (Deutsche Bundesbank, 2025).

247. In order **to anchor European procurement more firmly in the EU budget**, the **composition of the EU budget** could be **prioritised more strongly in favour of European defence spending**. A large part of the expenditure in the MFF has so far been allocated to agricultural and cohesion policy. The funds flow primarily to economically weaker EU member states (Deutsche Bundesbank, 2025). On the other hand, the **EU budget** could be **increased through higher contributions from member states**. However, it should be ensured that the additional funds are assigned to defence spending. If procurement measures are shifted from the national to the European level, expenditure would also be shifted from the national to the European level. This has advantages in terms of desirable coordination, but also creates risks in connection with joint financing.

248. **However**, **both options** can **only be implemented in the medium term** and **involve low financing volumes**. The future MFF does provide for a significant increase in funding for defence and space, at €131 billion (European Commission, 2025f). However, measured against European GNI in 2024, this corresponds to only 0.1 % of GNI per annum. The EU member states should advocate for the European Commission's proposed reprioritisation in favour of a higher research and defence budget ↘ ITEM 247 to be more ambitious in order to increase defence spending.

To ensure that the funds are **assigned and** used **transparently** for joint procurement, the EU budget funds made available through reprioritisation or increases should be made **available to the EDM as a procurement agency for joint procurement**. In addition, the funds allocated to the EDM could be increased via a contribution rate. As with the EU budget, this could be based on a share of national GNI.

249. In order **to quickly address** the existing **shortfall in defence**, **debt financing** as outlined in the ReArm Europe Plan can be **considered in principle**. In this context, the specific financing requirements should be quantified in advance in a transparent and comprehensible manner in order to avoid already planned expenditure being covered by debt retrospectively. However, national borrowing can further restrict the fiscal space of countries with already high debt ratios. Furthermore, joint liability at European level poses considerable incentive problems: if risks are shared, the incentive for individual member states to pursue sound and sustainable fiscal policies is reduced. Countries could expect that excessive debt will ultimately be absorbed by the community, resulting in inefficient use of funds and increasing fiscal divergences within the EU.

4. Conclusion: Defence

250. In order to **close capability gaps** and **strengthen Europe's defence capabilities**, defence procurement should be coordinated more closely at European level. **Pooling demand** would increase the purchasing power of member states,

create cost advantages and promote the harmonisation of technical standards. ↘ ITEMS 229 F. At the same time, **national procurement procedures** should be made **more flexible** in order to increase responsiveness. ↘ ITEM 231 **Performance-based contract models** can also ensure that costs and schedules are reliably adhered to. ↘ ITEM 234

251. For **military innovations**, it is important to specifically **promote** the **development of new technologies** in Europe. One possible approach is to establish a European institution similar to the DIU in the United States, which brings dual-use goods to operational readiness more quickly and opens up access to venture capital and innovation networks. ↘ ITEM 239 In addition, it would make sense to create a European counterpart to DARPA in order to drive disruptive innovations in military research and development, pool resources and achieve economies of scale. ↘ ITEM 241

252. The **financing of European defence capabilities** should **be organised jointly from the EU budget**, with a distinction being made between **permanent expenditure** and **short-term catch-up needs**. This should involve an increase in funding and prioritisation of defence expenditure, as already provided for in the future MFF. ↘ ITEM 247 Financing through European debt, for example as part of a ReArm Europe plan, can help to close short-term capability gaps, but poses risks to fiscal stability and incentive structures. ↘ ITEM 249

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