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Hubertus Bardt

Industrial Policy and a Single Market for Defence Goods

Seventy years after the failure of the European Defence Community and 35 years after the fall of the Iron Curtain, joint defence efforts at the European level are back on top of the political agenda. The combination of new threats associated with the Russian invasion of Ukraine and the questions regarding the credibility of US support within NATO are forcing Europe to increase its military capabilities. Although the United States has by far the largest defence budget, the defence expenditure of EU member states totals two-thirds of the US budget. Considering the fact that the US is, in contrast to Europe, very active in the Pacific region, the level of spending in Europe is comparable to that in the US. However, the military capabilities are much weaker. One important reason for the low efficiency of military spending in Europe is the huge degree of fragmentation: there are defence administrations in each country, separate planning and command structures. The military units are separated, and the rules of engagement and political control structures are different and distinct.

Traditionally restrictive policy for the defence industry

For decades, the defence industry has not been the focus of economic policy debate. When companies that produce military goods have come to the attention of the public, it has usually been with a critical connotation. The export of weapons was handled restrictively, and some countries have taken a particularly restrained approach to export licences. This has affected dual-use goods, i.e. civilian goods that can also be used for military purposes. The critical environment was also reflected in the discussion about sustainability criteria. As a result, producers of defence equipment were often classified as unsustainable across the board, making it more difficult for companies to access the capital market.

On the sales side, the industry has been under pressure for two reasons. Firstly, military procurement has been systematically reduced after the end of the Cold War, resulting in huge peace dividends (Bardt, 2021). This trend has reversed only recently in Germany, while defence budgets have been increased in other countries. France and the United Kingdom have similar defence budgets but have continuously spent 0.4% to 0.5% of their GDP on defence equipment and recently increased this figure to 0.6% (Figure 1). The German level was significantly lower at 0.1% to 0.2%. Although the increase to 0.4% in 2022 and 2023 is relatively high, the level is below that of neighbouring European countries despite the proclaimed turnaround. This is particularly striking in comparison to Poland. With equipment expenditure of 0.4% to 0.7%, the figure was already high in the last decade in Poland. With the threat from Russia, the level of spending increased to 2% of economic output. The proportion of equipment is consistently high in the US, where 1% of GDP is spent. In absolute terms, the US spent approximately US \$250 billion dollars on defence equipment in 2023 (Figure 2). Germany, France and the UK were far behind at US \$17 billion, \$16 billion and \$19 billion, respectively. Poland reached a comparable level of US \$15 billion despite its significantly lower economic output. The total of all EU member states is about one-third lower than the US level, with far fewer military activities in the Pacific region.

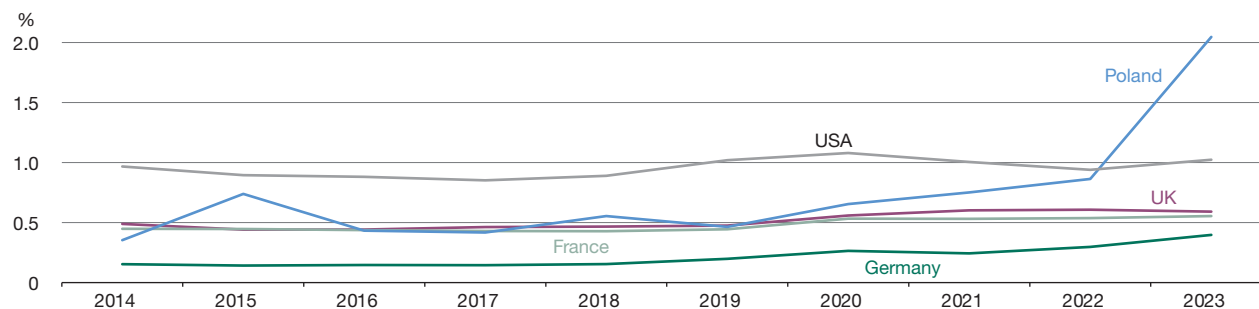
European defence, the defence industry and military equipment are highly fragmented. There are far more different types of systems than in the US, as many governments favour products from domestic suppliers. The lack of standardisation and the low production numbers increase the costs. Economies of scale cannot be realised, and production capacities cannot be optimised and utilised when huge development costs have to be borne several times instead of distributing them to larger production units. The smaller sales market also means that companies are less competitive and the pressure from competition to innovate is therefore less effective. More competitive markets would tend to reap advantages for defence capabilities in terms of costs and performance. Nationally defined arms export policy not only affects the national defence industry, but also has an impact on European cooperation (Röhl, 2022). This is necessary in order to combine complementary competences, share development costs through larger quantities and limit the variety of systems deployed in the alliance. If export restrictions are designed with varying degrees of rigour,

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Figure 1
Expenditure on defence equipment as a share of GDP



Note: Figures for 2022 and 2023 are estimates.

Source: Author's own calculation based on NATO data.

the export opportunities of the international consortium will be determined by the home country with the most restrictive policy. This reduces the willingness of companies from other countries to cooperate, as they lose their ability to export.

Industrial policy for the defence industry or “war economy”?

Defence industry policy was on the agenda 70 years ago and it is on the agenda again today. The Draghi report devotes one of the focus topics to this industry. Defining a European approach for the defence cooperation and the defence industry is a central task of the new European Commission. The conditions for the defence industry have changed fundamentally, at least since with the Russian war of aggression against Ukraine (Röhl et al., 2022).

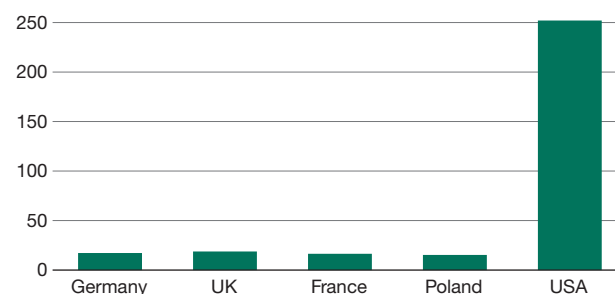
In response to the current security situation and the war in Ukraine, the term “war economy” has emerged in the public debate. A war economy is an economic system in which economic activities are largely subordinated to military requirements. This includes, in particular, the conversion of production from civilian to defence goods. In an essentially market-based economy, this can be achieved through subsidies or similar measures, but collectivist approaches are also possible. A war economy also includes the planned, collectively secured procurement of raw materials, often involving endeavours to achieve self-sufficiency. It also addresses typical financing problems in the public sector, which often lead to hidden inflation and inflation that manifests more prominently over time. The term “war economy” does not reflect the current situation in the EU; it overdramatises the economic reality. There is no fundamental transformation of our economic order towards a semi-planned economy. Nevertheless,

the question arises as to which policy approaches can be used to adapt the defence industry to the changing military requirements, especially if these go beyond normal and continuous procurement processes. Within a market economy, providing military goods without supply risks in times of international conflicts may require a specific industrial policy. This fits into the current debate on industrial policy in Europe.

Three different perspectives can be distinguished in the current industrial policy debate (Bardt & Lichtblau, 2020; Bardt, 2024b). First, most economists are in favour of improving investment conditions (Fuest, 2019). This can also be referred to as horizontal industrial policy. Second, there is a much more critical view regarding an interventionist industrial policy, where the state actively supports specific companies or company mergers in order to gen-

Figure 2
Expenditure on defence equipment in billion US dollars

2023, estimate



Source: Author's own calculation based on NATO data.

erate future competitive advantages for certain domestic market participants through market distortions and restrictions on competition (Busch, 2009; Röhl & Rusche, 2019).

The third perspective concerns the industrial policy consequences of external, mostly political, developments, which are less straightforward (Hüther et al., 2023). For example, in climate policy, the European CO₂ price level is intended to internalise the external effects of emissions, but it also creates distortions of competition at the expense of domestic producers. The strict deadline for decarbonisation leads to a considerable need for additional investment, which is not matched by equivalent production capacities. If these additional costs de facto demanded by the state cannot be refinanced on the market, the question arises as to the resulting need for industrial policy action. Similarly, specific interventions can be justified if distortions of competition by state-capitalist China need to be offset (Matthes, 2024) or if diversification measures that do not pay off in microeconomic terms are necessary to ward off the potential for political blackmail. This third perspective also includes the considerations that need to be made with regard to the defence industry (Mölling & Schütz, 2024).

The focus is on a single sector – with supplies and complementary products and services from other sectors. It is therefore necessary to identify specific justifications and instruments that go beyond general horizontal industrial or location policy. As defence goods are produced in various industries, a targeted policy approach is even more difficult. Furthermore, these companies typically manufacture military and civilian goods, and the categorisation is often not clear even at the product level. Dual-use goods can be used for both civilian and military purposes. As a result, there is a risk that the promotion of certain companies to strengthen the production of defence goods in whatever form will simultaneously boost their position in civilian markets as well, thus creating new distortions of competition in these civilian sectors.

A special industrial policy for a group of companies requires particular justification in a market economy in which general rules should apply. External security is a classic public good that can best be provided by a state organisation that is financed through taxes. In Germany, this is the Bundeswehr, which is integrated into the overarching alliance structures of NATO. However, this does not mean that the supplies are also in the hands of the state. Nevertheless, they must be just as reliable and, in principle, available at all times, even if they are not needed most of the time.

Justifications for a special industrial policy for the defence industry

In order to maintain external security, even in the event of a conflict, a country's technological capabilities must be secured. Deliveries from third countries could jeopardise defence capabilities if necessary spare parts or replacement deliveries can be refused for political reasons. It can therefore be argued that critical defence equipment should be produced domestically, in the EU or by an ally.

In the event of a crisis, defence equipment must be produced and delivered quickly and in large quantities. However, the capacities required for this are only utilised to a small extent at normal times. It is also very uncertain whether there will ever be extensive demand to finance the capacities. It can therefore not be assumed that the necessary production facilities will be spontaneously made available on the market. Capacity planning and financing requires the coordination and involvement of the central government client.

In addition to capacities for original military goods, which are not utilised over long periods but should be available for emergencies, civilian production may also have to be converted in order to provide components for the defence-related value chain. It is therefore necessary to define the areas in which emergency production must be prioritised over civilian orders. Here, too, production among allies can be advantageous, so that no decisions by third countries can delay production. Additional costs may arise, particularly for the additional flexibility needed for adaptable production capabilities. These costs must be financed as part of the defence budget.

In the context of military technology, existing innovative advantages are of particular importance. These can be the decisive advantage in the event of a conflict. It is not only the defence equipment itself that is relevant here, but also important components that are produced by suppliers and may also be used and marketed in completely different applications. This means that certain innovative advantages should not be made accessible to third parties, particularly potential adversaries. This restricts the companies' ability to utilise their own innovations – for both military applications and corresponding civilian goods. The promotion of innovations, securing of advantages within the alliance framework and the targeted demand for innovation to catch up may require government action.

Technological developments for military purposes have the potential to have positive spillover effects on other civilian areas. This can be the case, for example, in the development of aircraft, navigation technology or sensor

technology. If the benefits of these innovation spillovers cannot be internalised through lower procurement costs, the government has an industrial policy interest in allowing these benefits to take effect domestically and not in third countries. There is a very fine line here between this and traditional industrial policy considerations – after all, the awarding of military development and procurement contracts can be used to organise tangible support for the contracted companies.

National suppliers may have to be favoured if they are massively restrained in their business opportunities by tight export restrictions. From the producers' point of view, the home country has considerable market power, which is linked to the possibility of a ban on deliveries to other customers. Restricted export opportunities lead to lower quantities and therefore higher unit costs. These would have to be borne by the domestic buyer in order to secure domestic production and thus supply without political risks.

Finally, industrial policy intervention can be justified by the fact that targeted procurement or promotion can prevent competition from being restricted due to the fact that there is (still) only one relevant competitor. National providers can be supported and even created in order to end the existing dependency on a (foreign) monopolist or to create additional alternatives in competition.

How can defence capability be accompanied by industrial policy?

Industrial policy for the defence industry is pursued in numerous countries. The US, for example, explicitly focuses on the resilience of defence-related supply chains (Department of Defense, 2023). The German government describes the challenges facing the industry in the new era and identifies key technologies (Bundesregierung, 2024), and the Draghi (2024) report is also dedicated to the challenges facing the industry.

The social market economy as a competitive system is traditionally reluctant to allow specific industrial policy interventions by the state that distort competition or restrict its ability to function. Industrial policy instruments that are necessary in the external security value chain should also be competition-oriented as far as possible. With the simple reference to external security, attempts can be made to justify any state intervention – the protective tariffs on cars under Donald Trump were justified with reference to national security. However, measures that are compatible with a market economy must be specifically geared towards the particular requirements of the public good of external security. As the supply chains for this good ex-

tend deep into private sector structures, the risk of unnecessary restrictions and distortions of competition is high. The instruments must therefore be specified and limited with particular care. The main features of an industrial policy for the defence industry include the following considerations.

Defence procurement starts with stable public funding (Wolff et al., 2024). This is the only way to close the procurement gaps and justify longer-term investments in capacities and innovations from a business perspective. To date, however, there has been a lack of credible security in budget planning for the period after the special fund expires (Bardt, 2024a).

The regulatory framework for the defence industry and other companies and technologies in the value chain must be conceived in European terms (Küchle, 2005, 123; Hellemeier & Schilde, 2024). External security can only be achieved through international co-operation. Military conflict is not conceivable between European allies, so the supply chains can at least be organised jointly. The advantage of a single market is more intense competition, which limits the costs for public budgets. Capacities can also be better utilised if several countries have ongoing procurement requirements. Conversely, however, this does not mean that quotas for European procurement are appropriate. For example, the EU proposes that by 2030 at least half of procurements should be sourced from within the EU, at least 35% should be traded across borders within Europe and at least 40% should be procured jointly (European Commission, 2024). Top-down quotas would contradict the idea of a market-based industry and could damage competition.

Unless there are particular obstacles to this, companies in the transatlantic alliance should be given equal consideration – for example, in the recent German orders of 60 Boeing helicopters and 35 F-35 Lockheed Martin fighter jets. Production and maintenance capacities on the continent of the purchasing country can mitigate risks after the delivery has been made. However, the advantages of this co-operation require that such a competitive position is adopted by all partners and that no distortion of competition is to be expected from one side. This requires a NATO agreement on the defence industry.

In the case of additional procurement from suppliers from third countries, care must be taken to ensure that a rapid switch to secure suppliers is possible in order to avoid failures that could be politically motivated in the event of a conflict. Alternatively, this can be achieved by producing critical components within the EU or NATO. A lower threshold would be to build up a large stock of spare parts

with direct access and to establish maintenance capacities. A technology transfer must at least ensure maintainability. In order to not be cut off from the technology in the event of a conflict, the expertise could be deposited as security, so that it could be used in the event of a refusal to supply. However, such a measure would have the disadvantage that it could open the door to state industrial espionage if it were standard market practice. If the procurement of critical components from third countries cannot be secured, this option would be cancelled and only a purchase from an alliance supplier would remain.

A key quality of defence equipment is the innovative edge that can arise at various points along the value chain. If innovation backlogs are to be compensated for, funding must be organised in a very targeted manner. Promoting innovation among suppliers and critical subcontractors is therefore of central importance. To this end, the restrictions on cooperation between public universities and the defence industry must end. Competitive procedures should be used to promote innovation. This can avoid distortions of competition. In addition, advantages that arise in this way on third-party markets or for civilian products can lead to lower funding requirements.

Both preparation and financing are required in order to arrange and secure the necessary capacities and possible short-term conversion of production to products and components required for the security value chain in the event of a crisis. Following an assessment of requirements, a competitive process should be initiated in order to utilise the most efficient options with the least possible distortion of competition. The financing of such growth options – both from the changeover and from the provision of capacity – should take place through direct refinancing of the option costs determined in the competition.

Trade policy provides for restrictions on military and militarily usable dual-use goods. This can be extended to other goods in order to safeguard existing militarily relevant technological advantages. This would be a critical trend for the European economy, which is geared towards international trade and should be limited to what is absolutely necessary. Germany's particularly restrictive arms export policy should also be harmonised within the EU framework so as not to further hinder the willingness of European companies to cooperate.

Towards a European approach

A European industrial policy for the defence industry is necessary in order to meet the special requirements and

restrictions associated with the goods in the external security value chain. At the same time, such a policy is associated with a considerable potential for abuse, favouring certain (national) companies through hidden distortions of competition. By creating a competition-based single market and by limiting interventions to those that are necessary, damage that can also be caused by interventions in related civilian markets can be avoided.

As a prerequisite, member states must agree that the regulatory framework for the defence industry and related, irreplaceable companies and technologies in the value chain must be conceived in European terms. A central justification of industrial policy in the defence sector is the necessity of securing (und speeding-up) production in a military conflict; therefore, companies from European countries and NATO allies (and similar countries) should be considered reliable suppliers. Creating a single market for defence goods within the EU would be a goal that Europe can achieve independently.

The advantage of a single market for defence goods is the more intense competition, which limits costs for public budgets. The greater diversity also helps to secure supplies if individual suppliers should fail. Capacities can be better utilised if several countries have ongoing procurement requirements. Competition is key for efficiency and innovation. Industrial policy for the defence sector should not follow top-down planning approaches. European policymaking should focus on strengthening the defence industry by committing to long-term procurement, supporting innovation, co-financing emergency capacities and improving cross-border competition. One of the most difficult tasks is to commit to Europe-wide purchasing that is not nationally discriminatory.

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