

Issues in European Defense Spending (II)

Price inflation: Not enough capacity to cover the surge in demand

- A surge in defense demand following Russia's invasion of Ukraine collided with limited industrial capacity, driving inflation and preventing increased spending from translating into proportional gains in deployable power.
- Supply constraints, coupled with increased armament costs, have turned financial efforts into diminishing returns.

Introduction

Russia's invasion of Ukraine in 2022 triggered a demand surge for defense material.¹ The sharp rise in European defense budgets exposed a critical weakness: the continent lacks sufficient industrial capacity to absorb a rapid surge in demand. Inflationary pressures and supply bottlenecks have undermined the translation of increased defense spending into usable military capability.²

Demand shock

After the Russia-Ukraine war started, European governments moved quickly to replenish depleted stockpiles, particularly in ammunition, air defense systems, and precision-guided munitions.³ However, this surge occurred after decades of underinvestment in defense manufacturing capacity.⁴ Production systems were unable to scale at the required pace, leading countries to compete for limited output rather than to benefit from coordinated procurement.

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Industrial limitations – not funding – have become one of the primary obstacles to strengthening European military capabilities. Scaling up production requires long-term investment, workforce expansion, and supply chain restructuring, none of which can be achieved quickly.

Supply constraints

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The EU's effort to supply Ukraine with artillery shells revealed severe production capacity constraints, with output initially falling far short of targets.⁵ But supply-side constraints extend beyond ammunition. Missile production is limited by complex, multi-tiered supply chains that rely on thousands of scarce components.⁶ Advanced electronics depend heavily on global semiconductor markets, leaving European defense firms exposed to external disruptions. At the same time, labor shortages, particularly in specialized engineering and technical roles, further restrict output. These structural bottlenecks have led to significantly longer lead times, with some major systems facing delivery delays of several years.⁷

Increased armament costs

Europe is transitioning toward technologically sophisticated military systems, including drones, cyber capabilities, AI-enabled platforms, and precision-guided munitions. These systems depend on scarce high-end components and highly specialized labor embedded in vulnerable global supply chains, creating persistent upward pressure on costs.⁸

Defense inflation dynamics

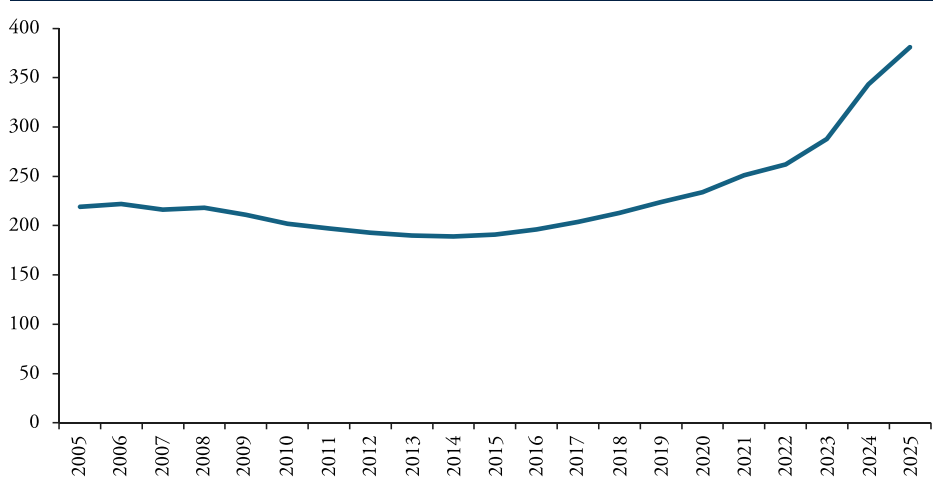
The result has been a form of defense inflation, where increased spending does not translate proportionally into increased capability. Rising unit costs reduce the quantity of equipment that governments can procure, while delays undermine operational readiness. Heightened demand combined with constrained supply has driven price increases across multiple categories of military equipment. In practical terms, this means that even historically large budget increases are partially absorbed by higher costs rather than generating new capabilities.⁹

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Conclusion

Addressing these challenges requires institutional reform. Greater coordination at the EU-level, targeted investment in industrial capacity to expand production and shorten lead times, and a balanced focus on both high-end systems and scalable technologies can convert growing defense budgets into real military capability. Without such changes, Europe risks entrenching a system in which higher spending continues to yield diminishing returns.

EXHIBIT 2.0 – EU DEFENSE EXPENDITURE, 2005-2025 (EXPENDITURE IN BILLIONS OF EUROS)



Source: The Council of the EU.

**EXHIBIT 3.0 – TOP 10 EUROPEAN DEFENSE COMPANIES BY REVENUE, 2024
(MILLIONS OF U.S. DOLLARS)**

Company	Country	Revenue	Global Ranking
BAE Systems	United Kingdom	32,260	6
Thales	France	15,901	10
Leonardo	Italy	13,823	13
Airbus	European	12,705	14
Rheinmetall AG	Germany	8,245	18
Rolls-Royce	United Kingdom	5,698	25
Saab	Sweden	5,542	26
MBDA	European	5,305	27
Safran	France	5,198	29
Naval Group	France	4,761	32

Note: Currency values reported in non-U.S. denominations were converted to U.S. dollars using the IRS annual average exchange rates for 2024.

Source: Defense News.

Notes

- ¹ <https://sjms.nu/articles/303/files/678f8f1f86df6.pdf>
- ² <https://carnegieendowment.org/research/2025/12/rebalancing-the-transatlantic-defense-industrial-relationship-regional-pragmatism-in-northeastern-europe#footnote-17>
- ³ https://commission.europa.eu/document/download/97e481fd-2dc3-412d-be4c-f152a8232961_en?filename=The%20future%20of%20European%20competitiveness%20_%20A%20competitiveness%20strategy%20for%20Europe.pdf
- ⁴ <https://www.atlanticcouncil.org/in-depth-research-reports/issue-brief/immediate-steps-that-europe-can-take-to-enhance-its-role-in-nato-defense/>
- ⁵ *Ibid.*
- ⁶ <https://www.csis.org/analysis/europe-needs-asap-program-air-defense>
- ⁷ [https://www.europarl.europa.eu/RegData/etudes/BRIE/2024/762320/EPRS_BRI\(2024\)762320_EN.pdf](https://www.europarl.europa.eu/RegData/etudes/BRIE/2024/762320/EPRS_BRI(2024)762320_EN.pdf)
- ⁸ <https://www.nationaldefensemagazine.org/articles/2026/2/9/defense-sector-inflation-threatens-to-eat-away-at-budget-plus-ups#:~:text=The%20big%20boosts%20in%20defense%20spending%20will,both%20create%20what%20is%20taught%20in%20every>
- ⁹ <https://www.nts.org/news-and-archives/2026/2/9/defense-sector-inflation-threatens-to-eat-away-at-budget-plus-ups#:~:text=Defense%20Sector%20Inflation%20Threatens%20to%20Eat%20Away%20at%20Budget%20Plus%20DUps>