Flash Economics

N° 26
March 13, 2025

How to increase public investment and military spending in the euro zone?

The Draghi report shows that the shortfall in investment in Europe (to cover the needs of the energy transition, the digitisation of the economy and the financing of disruptive innovations) amounts to 5 points of GDP per year, half of which is borne by businesses and the other half by governments.

In addition, the euro zone countries will have to increase their military spending (which, in 2024, represented 2.1% of GDP in Germany, the Netherlands and France, 1.5% of GDP in Italy and 1.3% of GDP in Spain; the euro zone countries that dedicated the highest proportion of GDP to military spending are the Baltic States, Finland and Greece; the countries that dedicated the lowest proportion of GDP to military spending are Spain, Slovenia, Belgium, Austria, Malta and Ireland).

Raising military spending as a proportion of GDP to the level of the United States (3.4%) would mean increasing it by 1.6 points of GDP for the euro zone countries as a whole. All in all, we can see that public spending (implementation of the Draghi plan and increased military spending) should increase by 4.1 points of GDP in the euro zone. Given the projected public deficit in the euro zone (3.1% of GDP in 2025), this additional spending can only be financed by transferring what are currently public activities to the private sector, as Sweden did from the mid-1990s onwards with the opening up to competition of public transport, health services, the post office, retirement homes, nursery schools, telecommunications, etc.

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Massive need for additional public spending in Europe

Mario Draghi's report estimates the need for **additional investment in Europe at 5 points of GDP**, half from the private sector and half from the public sector. The aim is to finance the energy transition, the digitalisation of the economy and disruptive innovations.

In addition, **if the euro zone countries were to align their military spending as a percentage of GDP** (**Table 1**) with that of the United States (3.4% of GDP in 2024), the euro zone would have to dedicate an additional 1.6 points of GDP to its military spending.

Table 1: Military expenditure (as % of GDP)

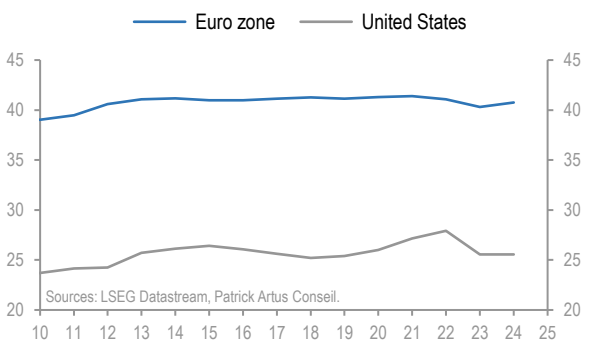
Country	Military expenditure
Estonia	3.43
Latvia	3.15
Greece	3.08
Lithuania	2.85
Finland	2.41
Germany	2.12
France	2.06
Netherlands	2.05
Slovakia	2.00
Croatia	1.81
Cyprus	1.80
Portugal	1.55
Italy	1.49
Belgium	1.30
Luxembourg	1.29
Slovenia	1.29
Spain	1.28
Austria	1.00
Malta	0.80
Ireland	0.20

Sources: OTAN, CIA

In total, when we add the increase in public investment recommended in the Draghi report to the need for an increase in military spending, **we end up with a need for additional public spending of 4.1 points of GDP**.

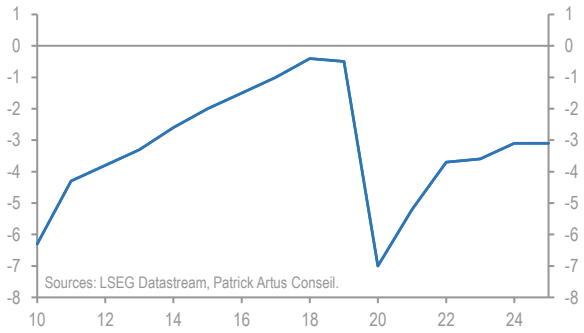
This additional public spending would not be financed by an increase in the tax burden in the euro zone (**Chart 1**), given the background of fiscal competition between euro zone countries and between the euro zone and the United States.

Chart 1
Tax burden (as % of nominal GDP)



It is not possible to substantially increase the public deficit in the euro zone (Chart 2).

Chart 2
Euro zone: Fiscal deficit (as % of nominal GDP)



The most likely outcome is that the increase in public spending suggested by the Draghi report and the necessary rise in military expenditure will have to be financed by a decrease in other public spending (Chart 3).

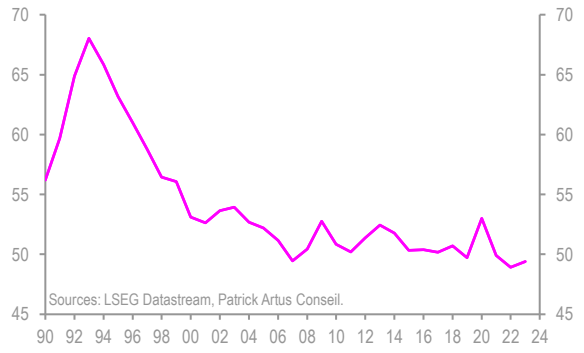
Chart 3
Euro zone: Public spending (as % of nominal GDP)



The euro zone will need to follow Sweden's example

From the mid-1990s onwards, Sweden opened many public services to competition, including public transport, health services, the post office, retirement homes, nursery schools and telecommunications. As a result, public spending fell sharply (Chart 4) because it was partly converted into private spending.

Chart 4
Sweden: Public spending (as % of nominal GDP)



In addition, the reduction in the weight of public spending in Sweden stemmed from a **significant improvement in the productivity of the public sector** with the introduction of the Agencies, each of which carries out a government function, employs mainly private-sector employees and is evaluated regularly.

This transfer to the private sector of functions entirely performed by the State has made it possible **to reduce the tax burden** (but, of course, the Swedes have had to bear the cost of the services that have been privatised), **Chart 5, and to increase forward-looking public spending**, such as on research and development (**Chart 6**).

Chart 5
Sweden: Tax burden (as % of nominal GDP)

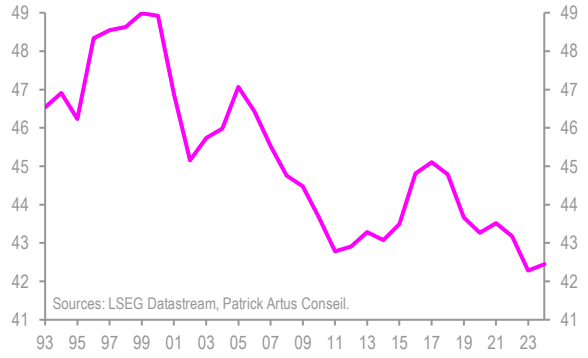
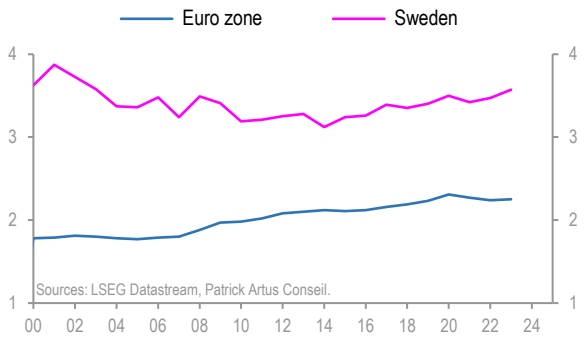


Chart 6
Total R&D spending (as % of nominal GDP)



Summary: faced with new public spending requirements, the euro zone will have to adopt solutions similar to those adopted in Sweden 30 years ago

We estimate **the need for additional public spending in the euro zone** (linked to the implementation of the Draghi report and to increased military spending) at 4.1 points of GDP. We believe that it will not be possible to finance these new requirements by raising the tax burden or by increasing the public deficit.

The only solution is therefore to:

- Increase public sector productivity;

- Open up selected public services to competition (which amounts to transforming public spending into private spending).

The more the productivity of the public sector can be improved, the less this transfer from public to private will become a burden for households and businesses. In Sweden, from the mid-1990s onwards, it has been possible to concurrently reduce public spending and the tax burden by opening up selected State functions to competition and by radically reforming the way the State is organised.

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