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BertelsmannStiftung

Policy Brief

How to defend Europe without risking another euro crisis

21 February 2025

Lucas Guttenberg, Senior Advisor, Bertelsmann Stiftung
Dr. Nils Redeker, Deputy Director, Jacques Delors Centre

Europe intends to rapidly and strongly increase its defense spending. It should do so without risking Europe's fiscal sustainability and financial stability at a time of great danger. We argue that the Commission's current plan to use the flexibility built in the EU's fiscal rules will not achieve this: On the one hand, this will not lead to the long-term certainty over available resources for defense spending that is now needed. On the other hand, relying on the flexibility and in particular the use of the national escape clause would likely amount to an unplugging of the rules that could stoke strong market reactions. Therefore, the best way to create the necessary fiscal space is a targeted and temporary exemption of defense spending from the fiscal rules. We outline how this could be done through a change of the legal texts. Finally, we explain how common borrowing could complement a rule change if member states agree to pool decision-making powers in defense policy matters.

Europe is intent on a rapid and strong increase in defense spending. It should do so without stoking market fears about countries' ability to honor their debts. The last thing Europe needs right now is a repeat of the euro crisis on top of the myriad dangers it is already facing. At the Munich Security Conference, Commission president von der Leyen announced that she wants "to activate the escape clause for defense investments", acting in a "controlled and conditional way". While such a clause does not exist (see below), that formulation highlights the fine line decision-makers are walking right now between the required ramp-up of defense spending and the need to maintain fiscal sustainability and financial stability. Unfortunately, not all European leaders seem ready to acknowledge this conundrum. Emmanuel Macron, for instance, considers the Stability and Growth Pact "obsolete"; "[t]he financial and monetary framework we live in is outdated."

We beg to differ: Precisely because Europe must reinvent itself when it comes to defense and security policy, safeguarding the credibility of its macroeconomic framework with the fiscal rules at its core is crucial. The framework was changed over the past fifteen years in a heated and highly divisive process; but it was worth it because the framework has improved dramatically. The case for further evolution is ineluctable and in this paper we outline how this can take place. But pretending such a framework is redundant or that it can be discarded and rebuilt in parallel to reshaping Europe's defense structures seems delusional: The eurozone remains an incomplete monetary union with a common currency and largely decentralized national fiscal and economic policies. This comes with built-in pitfalls and risks that still require a reliably solid governance framework.

Fortunately, a **massive increase in defense spending is feasible without throwing away the rules**. To do so, the fiscal rules must be adapted to the new reality: EU member states that can afford taking on more debt should be given maximum leeway to go on a credit-financed defense spending spree as soon as possible and for a long time. At the same time, the rules should continue to constrain those countries whose debt sustainability is already in question. This cannot be achieved properly by leaving the rules themselves untouched. The flexibility built into the rules - be it the national escape clauses the Commission seems to have in mind or a far more extensive use of the so-called "relevant factor" for defense - can only serve as a temporary band-aid. This sticking plaster will not give member states the long-term certainty about their fiscal space that is needed to enter into lengthy and large-scale procurement contracts. At the same time, the use in particular of the national escape clauses would de facto unplug the rules for a long time and could call into question their very existence.

Given these strong shortcomings surrounding today's built-in flexibility, it seems a much better option to change the rules in a targeted and temporary way: All extra spending that bridges the gap between the current two percent goal (or the status quo, whichever is higher) and the new to-be-determined spending target could be exempted from the rules until 2032. Below, we explain in greater detail how this could work.

Such a change in the rules could be complemented by tapping the EU's capacity for joint borrowing within an overall move to stronger integration in defense policy. The financial and legal plumbing required is not that complex. Here, the important unanswered questions remain what joint spending should focus on and how decisions on it will be taken and, critically, whether member states are really willing to give up and pool decision-making power.

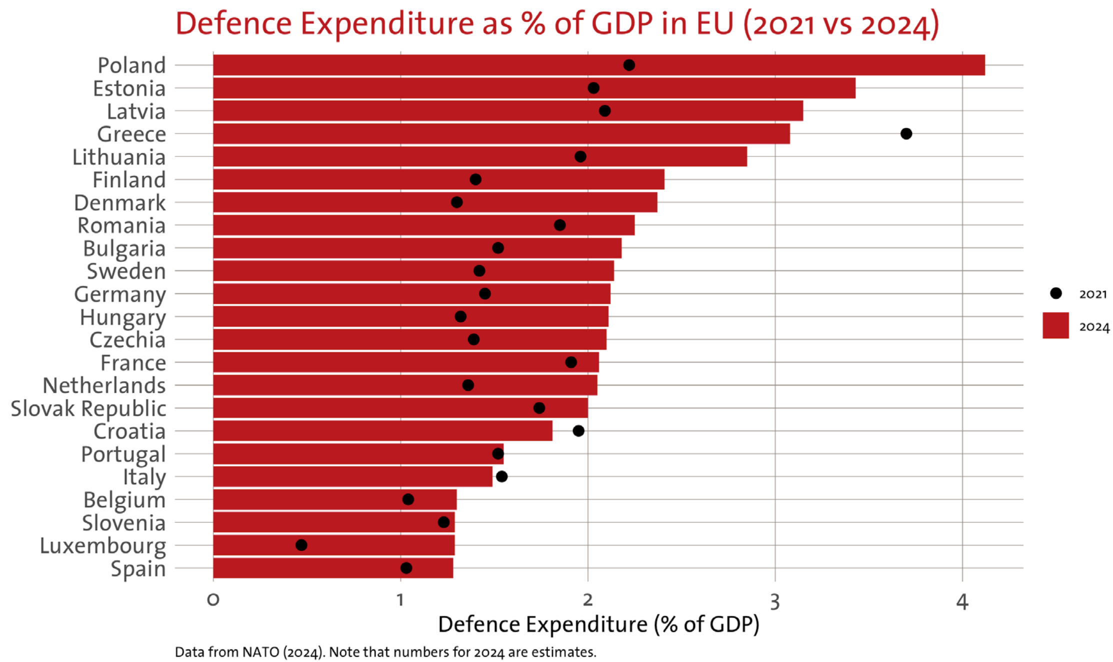
One important caveat for the remainder of this paper: We are experts in EU fiscal policy, not in defense matters. We cannot judge which military capabilities Europe really needs and how much it must spend to be safe from a Russian war of aggression. What we can do and what we offer with this paper is to show how any substantial increase in defense spending can be carried out without creating new problems for Europe's ability to act, its macroeconomic stability and its political cohesion in a period of great danger.

1. Why much of Europe can afford more debt but some cannot

There seems to be a unanimous consensus that European defense spending must quickly increase substantially. European armies suffer from decades of underinvestment. Prior to 2022, only a handful of national budgets met the NATO target of spending at least two percent of GDP on defense. Most member states undershot this goal; in some actual spending was closer to one percent or even below. Since Russia launched its full-scale invasion of Ukraine, defense budgets across Europe have risen substantially (Figure 1) and

NATO has changed its military planning assumptions.

But the increase since 2022 will certainly not be enough to meet the spending needs if Europeans are to take Europe's security largely into their own hands. How much member states will have to spend beyond the current two percent objective is as yet unknown and will be subject to debate in the runup to the June NATO summit. For the purpose of this paper, we assume that the increase will be large enough - a percentage point or more - that there is no way it can be met within the expenditure limits countries have agreed with the Commission.



Defense spending is usually not systematically conducive to growth or growth potential. It can have positive growth effects but that is usually more by accident than design given that the latter is to maximize security, not growth. In the long run, that means such spending should be covered either by tax increases or budget cuts elsewhere and not by debt as it does not increase future debt service capacity.

But in the years to come, financing the majority of the surge in defense spending through debt still makes sense. Decades of underinvestment have left deep gaps that now need to be filled quickly. This means incurring massive upfront costs that can and should be spread over time. Moreover, raising taxes or slashing budgets on the scale needed to fund defense spending today would hit the economy at a fragile moment of low growth and very uncertain outlook. Doing so would also risk undermining political support for rearmament just when it's needed most.

What is more, member states now require planning certainty. They will need to engage in large-scale long-term procurement contracts. Only then can the industry ramp up production capacities with the genuine prospect of economies of scale that will drive down costs. It's not enough to clarify that debt financing is possible; clarifying how long it will last is vital as well.

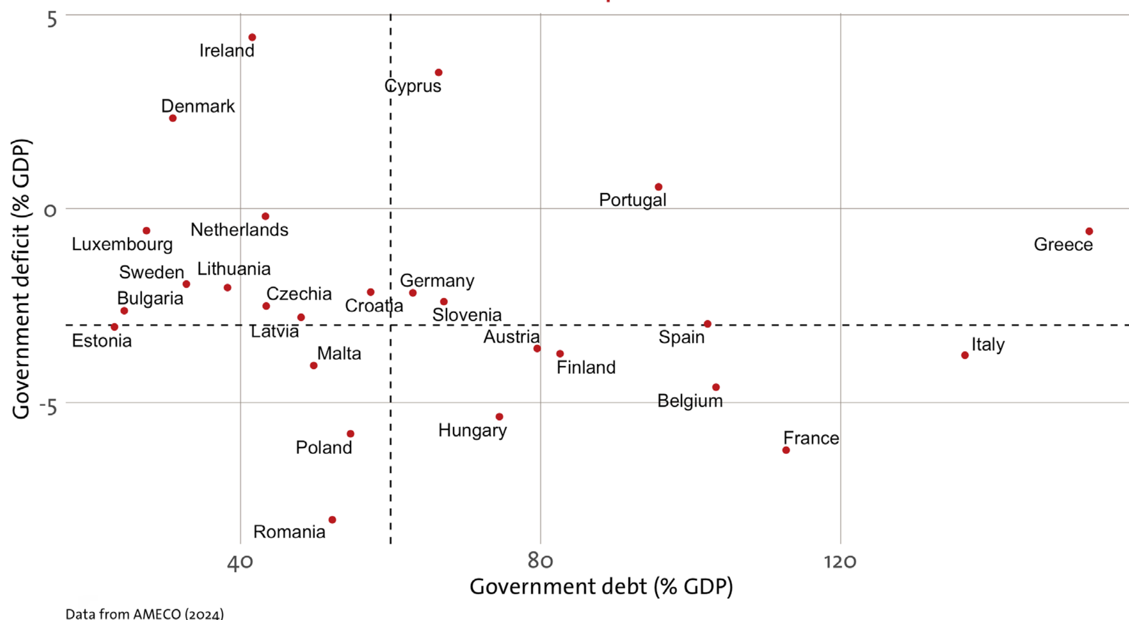
Debt financing is the preferable option and Europe can afford it. On aggregate, Europe can take on significantly more public debt. It can do so because it has a governance framework for fiscal and financial policy that actually works. This has dramatically improved since the euro crisis: The European Central Bank (ECB) has become a truly common central bank that protects its currency and supervises Europe's banks. The European Stability Mechanism

(ESM) and the ECB's Transmission Protection Instrument (TPI) provide massive firewalls against speculation. With NextGenerationEU, the EU for the first time borrowed jointly in markets to spend on common objectives on a large scale. And with the Economic Governance Reform, the fiscal rules have become much more grounded in economic logic. All these steps have taken a lot of time and political effort and have been at times highly divisive - yet it was worth it because ultimately the Union stayed together and is stronger for it.

But the framework is a package that cannot just be disentangled at will. The instruments of the ESM and ECB are predicated on the rules operating properly; the first condition to be eligible for the ECB's TPI is that countries adhere to the fiscal rules. The same goes for the ESM's precautionary credit line. The rules provide the political and economic cover for the emergency instruments to be activated where countries are hit by events truly not of their making. Take away the rules, the whole system falls apart.

This would not be a problem if all countries were beyond market doubts and in calm fiscal waters. But that is not the case. The ability to take on additional debt is distributed very unequally. Some countries have ample fiscal space to ramp up defense spending without any alarm bells, while others face tighter constraints. Broadly, they fall into three groups.

Government Debt and Deficits in 2024



Data from AMECO (2024)

The first group includes countries like Denmark, the Netherlands, and Lithuania, where debt and deficit levels remain comfortably below the Maastricht criteria. With no immediate constraints under the EU's fiscal framework, they can take on more debt to finance higher defense spending. The main challenge for these countries is to ensure that higher borrowing does not push them into breaching EU fiscal rules further down the line, which could make them act too timidly from now on.

The second group is restricted by the rules but economically still has room to maneuver. Countries like Germany and Finland whose debt is above 60 percent need to pay close attention to the rules. As we showed in a recent paper, Germany still could have some leeway under the rules in particular if it gets its economy going again. But these countries will not be able to increase their defense spending strongly over a very short time frame without coming into real conflict with the rules. As their debt levels remain low enough and their overall budgetary situation is such that sustainability concerns remain minimal, providing them more room to spend makes sense.

Then there's a third group of countries where debt sustainability is a real concern, with France and Italy being the most obvious examples. Italy's debt burden is very high at 137% of GDP, with a deficit nearing 4%. The IMF sees this as a "moderate" fiscal risk. However, this assessment hinges on mitigating factors, such as the ECB's ability to use its "toolkit against unwarranted, disorderly market dynamics that could seriously threaten monetary policy transmission across the euro area" (read the ability to apply the TPI if needed) and market confidence "that the new EU governance framework will deliver a significant and timely debt reduction."

France's public debt has surged to 113% of GDP, with the government struggling to rein in a deficit exceeding 6% and a highly volatile domestic political situation. The IMF saw France last year as experiencing "fiscal risks, as it leaves the future evolution of public finances exposed to an increase in sovereign interest spreads and volatility or a reduction in growth, which would compound already existing long-term fiscal pressures from the green and demographic transitions." Still, it assessed that "France's overall risk of sovereign debt stress remains low, considering France's commitment to undertake further fiscal consolidation, as per EU rules, as well as its liquid debt market". That points to the fact that the fiscal rules do indeed serve as an important anchor for France's fiscal credibility.

What makes their situation particularly volatile is that both are running high deficits in a period of decent growth; hence space to react to a possible downturn is already in short supply.

Ensuring debt sustainability for this group of countries is not a question of formal adherence to EU fiscal rules but a real macroeconomic necessity not only for them but for the Union as a whole. For them, removing EU fiscal guardrails entirely in the name of defense would be a serious gamble. Markets have already reacted nervously to signs of fiscal instability in France and Italy in the past. With a fragile global economy, rising trade tensions under a new Trump administration and persistent geopolitical uncertainties, now is hardly the time to test their patience. Keeping stricter constraints on these countries may force them to somewhat free ride on partners' rise in defense spending as their own will be slower - as France spent a lot on defense in the past a certain level of free-riding may well be particularly justifiable - but this is a far better outcome than risking a rerun of the euro crisis at the worst possible moment.

2. How the fiscal rules could give more space and why they need changing

The EU's reformed fiscal rules entered into force in their current shape last spring. Their application now comes in two phases: First, countries negotiate with the Commission an expenditure path that will bind them for the next four or five years. It is calibrated to plausibly bring national debt onto a downward path at the end of a four-year planning period and fulfill a number of numerical criteria along the way. Member states can extend the time horizon over which the path is calibrated to seven years if they commit to reforms and investments, but the agreed expenditure path is still only binding for four or five years. Second, the Commission monitors compliance. If a country overshoots its agreed expenditure path too strongly and if its debt is above 60%, it can be put in an "excessive deficit procedure" (EDP) where it will be set a more demanding course and which carries reputational costs. In an EDP, violating the spending limits eventually can be punished by the Commission and the Council with financial sanctions.

23 member states have so far agreed with the Commission their path for the years 2025 to 2028 or 2029. 17 of them are in the so-called preventive arm, i.e. not in an EDP. Six are in an EDP because their deficits were greater than 3% in 2023 (France, Italy, Slovakia,

Romania, Poland and Malta). None of these plans contains leeway for the kind of massive expenditure increase on defense described above. In all member states, it would very likely result in a punishable deviation from the agreed path. For those in the preventive arm that are above 60%, this would normally result in an EDP. In addition, for at least some countries the increase would likely bring the deficit above 3%, normally triggering an EDP regardless of the debt level. For the six already in the EDP, such a deviation would lead to more pressure to consolidate and eventually at the very end of the road to sanctions.

Austria, Belgium, Bulgaria and Germany are in a special situation as they have not yet agreed a path with the Commission because of either prolonged processes of forming a government or imminent elections. Here, the problem is mainly that the rules for calibrating the expenditure path do not factor in the necessity to increase defense spending strongly. So, for these countries too the current rules will in all probability preclude the extra defense spending required now.

So, what to do? As explained above, many member states can and should take on more debt to finance an increase in defense spending. But they cannot do so – or at least will be less likely to do so – if the rules stand in their way. At the same time, some member states are very rightly in an EDP and should not go on a deficit-financed spending spree. For them, the rules provide important guardrails that should remain in place.

To solve this conundrum, two options are available within the current rules and the Commission seems to clearly eye the first one –activation of national escape clauses – as their preferred choice. As we show below, these options can help very temporarily but cannot solve the problem at hand.

a. Activation of national escape clauses

The Commission president speaks about an "escape clause for defense". However, there is no such a clause to hand. But here is what she was probably referring to: The rules contain two so-called "escape clauses" that the Council can trigger on a recommendation from the Commission. The first one, the "general escape clause", unplugs the rules entirely for all member states. This is what happened during the pandemic. It will be of no use in the present case because the precondition for its activation is a "severe economic downturn" in the EU as a whole or the euro area on its own.

The rules also contain a "national escape clause" for individual countries. It can be activated "where exceptional circumstances outside the control of the Member State have a major impact on the public finances of the Member State concerned". It seems obvious that the Russian aggression against Ukraine combined with the recent announcements of the new US administration constitute exceptional circumstances outside the control of individual member states – and if the increase in defense spending that flows from these circumstances is very large, then also the criterion of a "major impact on the public finances" should get a check. In addition, activating it must "not endanger fiscal sustainability over the medium term".

Once activated for countries in the preventive arm, the control account that records deviations from the expenditure path stops recording. This effectively blocks the normal course for the Commission of putting a country into an EDP as the condition for this is the control account breaching either a yearly threshold of 0.3 percent of GDP or a cumulative threshold of 0.6 percent of GDP.

So, once the national escape clause is triggered for a country, it is basically free to opt for as much deficit-spending as it wants and on whatever it chooses if its deficit does not transgress 3 percent. Importantly, this is not confined to any specific expenditure item. This is not a defense-specific escape clause, it is an all-encompassing escape clause.

If the deficit grows above 3 percent, the Commission still must examine whether to open an EDP even for countries for which the national escape clause has been activated. Here, the rules provide that if the deficit is above 3 percent because of the exceptional circumstances, then it can consider that deficit exceptional too and hence does not have to open an EDP. So, above 3 percent, the deficit has to be actually caused by an increase in defense spending to avoid an EDP.

For countries in an EDP, the implications of activating the national escape clause is more complicated. Here, the rule is that countries will have to show "effective action", i.e. actual consolidation efforts, for the "exceptional circumstances" to be considered. This means that countries in an EDP do not get the same free pass as countries in the preventive arm even if the conditions for the national escape clause are met. But as this is very much untested territory, it is unclear how much smaller the leeway will be in practice.

In principle, activating national escape clauses could be helpful to tackle the immediate problem: It can be done only for some countries and not for others and therefore is helpful to differentiate between those countries who should get more space and those who should not. Conditions must be met for each country individually for the clause to be triggered. The Commission could make clear that it will only consider large increases beyond the current two percent spending goal as "major impact" and that for countries with very high debt levels it considers adhering to their EDP recommendations as necessary to maintain "medium-term fiscal sustainability". This would weed out both countries that should not take on more debt and those that are not serious about increasing their defense spending.

But this solution also comes with one important downside and several big risks:

- The downside lies in its ad-hoc nature: Activating the clause is a very temporary feature. There is no specified limit on how long the national escape clause can be activated. However, it seems obvious that the longest it can last is until the end of the agreed path: Formally, the activation of the clause means countries get to deviate from the path – that does not work anymore once that path has expired. In addition, it is very likely it would initially only be activated for a shorter timeframe and would then result in repeated messy discussions about prolongations. Given that defense expenditure has to be ramped up now for a long time and that contracts in this area span over many years, it seems unlikely that a solution that provides such limited certainty over the time period can be really helpful. At the same time, de facto suspending the rules on all spending for many countries repeatedly over many years comes very close to hollowing out the rules entirely. Hence, the escape clause might be a good quick fix but not a particularly good medium- to long-term solution.

- The big risk of this solution is political: Whether using the national escape clause is a good solution to the problem at hand hinges to a large extent on its differentiated application. If the clauses are triggered for all member states, then the message will be that the rules are essentially suspended in the same way as they were during the pandemic. The Commission will be politically unable to hold countries to higher standards when they are in an EDP in that case. Then, there are no more guardrails for an undefined but likely very long time period. Markets could react strongly to that. But similarly, it seems at least very challenging for the Commission to propose activation

of the clause for a lot of countries but not for, say, France and Italy. If it wants to go down the route of using the national escape clauses, the Commission will have to ask itself very seriously if it will have the stomach to be as "targeted" and "controlled" as its president has announced at the Munich security conference. We have serious doubts here.

b. Clarification the use of the defense-related "relevant factor"

An alternative option would be for the Commission to clarify how it intends to implement the rules going forward. For the countries in the preventive arm, there is a hook that would allow for a lot more defense spending: The newly added so-called "relevant factor" for defense investment. How does it work? As explained above, when countries deviate from their agreed path, the deviation is recorded on a control account. Once the account hits certain thresholds while the country's debt is above 60 percent, the Commission must examine whether to put the country into an EDP. For this decision, it can consider a number of relevant factors such as the overall budgetary and economic situation and how it has changed since the path was agreed. Since the last reform, at the behest of Poland, a new relevant factor to be considered is "the increase of government investment in defense".

These relevant factors not only play a role for deviations from the path for countries above the 60% debt ceiling; they are also considered by the Commission in judging whether a country with a deficit above 3% should be put into an EDP as long as that country is below 60%. If a country is above 60% and its deficit breaches 3%, the relevant factors cannot be relied upon unless that deficit breach is only small and transitory. In addition, the relevant factors can also be considered for countries in an EDP when deciding whether to escalate the pressure on a country.

The legal texts mandate the Commission to look at all relevant factors in a balanced manner; the regulation only clearly says that if a country has "substantial public debt challenges", this should be considered a "key aggravating factor". Given the geopolitical situation, it seems feasible for the Commission to put strong weight on defense spending if the other factors such as debt sustainability do not drastically point in the opposite direction. In practice, the Commission could issue a communication clarifying that it will not put countries in an EDP for deviations from their path or breaches of the 3% criterion that can be explained by increased defense investment or by increased defense expenditure that accompanies this investment such as increased personnel costs to operate newly-acquired material.

This would mean that countries in the preventive arm would get a lot more freedom to increase defense spending as long as they don't meet the double condition of breaching both the 3% and the 60% threshold at the same time. It could also clarify that in the EDP, it will look at such spending increases as not warranting an escalation unless countries face substantial debt challenges. In keeping with the differentiation the rules include for the debt safeguard, this could mean all countries with a debt level higher than 90%.

Such a clarification would lead to exactly the differentiation that is necessary in the short run to allow a lot more defense spending for a lot of member states while keeping the guardrails in place for those with very high debt levels.

This solution also comes with several problems:

- First, the use of relevant factors is very limited when deciding whether a country should be put in an EDP once it violates both the 3% and the 60% thresholds. For several member states, this is a likely outcome if they increase their defense spending substantially for

a few years. For these countries, clarification of the use of the relevant factor provides very limited value if it is not followed by a reform of the rules themselves.

- Second, in the preventive arm the use of relevant factors is only relevant in the monitoring phase. However, this provides no solution for countries that have not submitted any plan yet like Germany. They would still have to submit a plan that would need to be in line with the rules while already planning for a substantial deviation after it is agreed. This would not be very helpful for the credibility of the rules.

- Third, this can only be a bridge for a few years. Once countries will have to draw up their plans again, they will have to fully conform with the rules and the intermittent increase in both deficits and debts resulting from the deviation of the path will make it only harder to agree on a new path. This would directly undermine the long-term certainty about defense funding that is needed to enter procurement contracts for many years.

- Fourth, there is still a political risk that an overuse of the relevant factor will result in a de facto suspension of the rules. That risk is arguably a lot smaller than for the national escape clauses because the eligible spending is clearly confined to defense spending and because there are more hooks to keep guardrails on high-debt countries. But the risk is still there.

c. Why changing the rules is preferable and how it could be done

Both options described above can help to bridge the time to a change of the rules but do not provide the kind of durable certainty for defense funding that is needed now to ramp up production capacities by handing out long-term orders in large volumes. This is because both solutions run into the problem that in the next plan period, paths would become even tighter. In addition, both options carry important risks that the rules could become de facto unplugged and thus the EU and the euro area in particular could run the risk of strong market reactions.

To avoid both problems, a targeted change of the rules themselves is the only plausible instrument of choice. As this will take at least a few months, the relevant factor option could be used as a quick fix to avoid the Commission putting unnecessary pressure on countries in its Spring package. This would not create the same path dependencies and message of de-facto unplugging as triggering the national escape clauses.

Changing the rules to exempt the necessary extra spending is the best and cleanest way to create a lot more room for an increase in defense spending without accidentally or intentionally killing the rules altogether. Doing so is not easy, neither in substance nor procedurally, but feasible.

Exempting defense expenditure from the rules is completely orthogonal to the functioning of the new framework. The underlying spirit of the reformed rules is that they should bring debt onto a downward path no matter what this debt had financed when it was issued. But keeping with this logic will clearly not allow for the deficit-financed defense spending Europe needs. This will become obvious at the latest when member states will again have to agree their expenditure paths with the Commission for 2029 onwards. If these paths will have to conform again to the rules as they stand today, this will create a cliff effect for defense spending that will deter countries from spending already in the immediate years to come.

Therefore a solution is needed – but this solution will necessarily create technical headaches for the implementation of the rules as it unavoidably departs from the current logic behind them. Such a solution could have four parts:

- First, the principle underlying the change could be to create space for moving from the current defense spending target of 2% of GDP – or from their current levels, whichever is higher – to a new, higher one still to be defined and that could be either country-specific or general. Let's call this spending to be exempted "extra spending". If countries are still not at 2%, finding the space to go to the old two percent target should not be exempt as it should have happened structurally a long time ago and should be financed structurally. If countries want to overspend their new target, they are of course free to do so but should also find space in their budgets for it. As the exempted extra spending should be financed structurally in the long run, the exemption can only be temporary. We propose to exempt until the likely end of the next period for which paths will be agreed, which will be in 2032-2034. To be on the prudent side, a common end date of 2032 would make sense. This would give member states enough time to adapt the rest of their budgets to the new reality. The exemption should cover military spending in the sense of the NATO spending targets. It does not seem advisable to link the exemption to additional conditions such as the participation in joint procurement or a "buy European" clause. This would lead to an overburdening of the rules and would put the Commission into an arbiter position for questions on which it has no expertise. If at all, such incentives should come from true common spending accompanied by appropriate governance arrangements. More on that below.

- Second, in the monitoring phase of already agreed paths, the extra spending should be netted out from the expenditure paths. This is already the case for other expenditure categories, namely for interest payments, cyclical spending on unemployment benefits, co-financing on EU programs and one-off expenditure. Netting out the extra spending would mean that monitoring path compliance would continue for all other spending items with countries being put into an EDP or procedural steps within an EDP being taken if there is a deviation.

- Third, the extra spending would be taken out of the calculations to calibrate a new expenditure path. This can happen in three instances: Some countries have still got to agree on a path with the Commission this year. Countries have the right to ask for a new path when the government changes. And currently-agreed paths expire in 2028 and 2029 and will have to be replaced by new ones. When calibrating these new paths, the extra spending would need to be disregarded for the requirement for debt to be on a downward path, for the deficit safeguard and for the debt safeguard. This goes both for the extra spending in the previous period that will have increased both deficits and debt as well as for prospective spending in the period of the new path. Practically, this would mean for the Commission to do double bookkeeping for the time of the exemption. It would continue to monitor overall debt dynamics including the extra spending without acting on it and would also have to advise countries on how to smooth the path towards the end of the exemption period to avoid cliff effects.

- Fourth, a change to the legal texts cannot mute the treaty obligations Commission and Council have in monitoring countries' fiscal policies. The most important consequence of this is the following: When countries breach the 3% deficit threshold because of the extra spending, the Commission will still have to examine whether to open an EDP. This could be mitigated by clarifying the relevant factor on defense along the lines of the exemption to avoid EDPs being opened because of the extra spending. It also means countries in an EDP will eventually have to bring their nominal deficit below 3% but the

Commission can play with the timeframe for doing so based on the relevant factors.

A tricky question is whether this exemption should apply to all member states or only to those with considerable leeway. If the exemption is as outlined above, several of the most indebted countries would not fully benefit from it: Spain and Italy are far below 2% and would have to finance the first part of the increase by reprioritizing within their budgets. Greece already overspends on defense. Only France would benefit fully from the exemption. We think that this would make sense in the context of a rule change: Unlike the options within the current rules outlined above, changing the substance of the rules would not take away any clarity about the implementation of the remainder of the rules. It would also not call into question the general commitment to adhere to the rules – these would not be "obsolete", quite the contrary. In this context, allowing France to benefit from the targeted exemption and to increase deficit and debt moderately because of it seems plausible.

Changing the rules would follow the normal legislative procedure. The proposal would need to come from the Commission and would then have to be agreed between Council and European Parliament. If this concerns only the preventive arm regulation, changes require a qualified majority of member states. If the corrective arm regulation also needs changing, then unanimity is required. The changes outlined above can almost all be implemented by only changing the preventive arm regulation. This even goes for netting out the extra spending from the EDP paths, as the definition of the categories to be netted out is done in the preventive arm regulation. But because a clarification of the application of the relevant factor will be necessary to avoid countries being put into an EDP because of the deficit criterion, there will also likely have to be a change to the corrective arm regulation. So unanimity will probably be necessary.

3. What about common borrowing?

Defense is and will remain essentially a national competence. Member states will likely not give up large degrees of control over what to buy and from whom to buy in defense matters. As long as this is the case, it makes sense that member states retain financial responsibility for these decisions. It will not be possible to explain to voters in any member state why they should be liable for repaying debt used to fund purely national spending decisions in another member state, in particular in an area such as defense where the inefficiencies of national bureaucracies are notorious.

Possible solutions to lower borrowing costs for member states by providing cheaper loans from the EU level via the ESM or a repetition of the SURE program also would not really contribute to the problem at hand, namely that member states need to put more money on the table for defense. For the vast majority of member states, financing conditions for additional spending are not the constraining factor. Rather, either the rules stand in the way or their budgetary situation makes it difficult to take on much more debt in general. Hence the political costs of setting up such a scheme - and the strong limitations on its governance that would come with using e.g. the ESM - likely by far outweigh the very limited benefits.

That does not, however, mean that the EU's capacity to borrow jointly should remain untapped. Since the pandemic, the EU has the technology to borrow funds that it can spend on common objectives. These funds can be distributed by majority decision at the EU level without the cumbersome involvement of national parliaments. From a technical point of view, the experience of NGEU could be repeated for defense spending and serve as a useful complement to the rules change outlined above. It seems likely that many envisageable expenditure categories would find an appropriate legal basis in the treaties, to do so is with the exception of spending related directly to military operations. To ensure appropriate

absorption of additional EU debt by markets at acceptable rates, the EU would need to confront a few leftover questions from NGEU, especially on new own-resources and whether to keep the repayment schedule as planned. But all in all, the legal and financial plumbing for such an operation seems entirely feasible.

But the all-important question here remains so far unanswered and as we are no defense experts, we cannot answer it either: What should the money be spent on and who decides on its distribution? Economically, there can be four very plausible cases: First, to nudge countries to engage in common procurement and to buy from European suppliers if the aim is to ramp up European production capacity. Second, to fund common projects that individual member states will or cannot sensibly fund such as common missile defense. Third, to invest in infrastructure that is useful for military mobility as such investment will likely be underprovided by individual member states because of its strong spillovers for the rest of Europe. And fourth, all expenditure related to securing and rebuilding Ukraine as this has a strong security spillover to the whole of the EU.

In each of these areas, member states would have to cede control to the EU level over major decisions that so far they take on their own. Because it is EU money, the Commission would need to be involved in administering the spending. It would be for defense experts to spell out what spending programs should look like but it seems no understatement to say that this would represent a major integration step in defense policy - call it a defense union or something else. The question remains whether member states are ready to take this step. Economically, it could make sense; technically, it is feasible.

Conclusion

It is possible to massively increase European defense spending without discarding the European macroeconomic policy framework and risking another euro crisis. The best way change the fiscal rules in a targeted way. This easing of the rules could be complemented by common borrowing by the EU provided member states agree what to spend the borrowed funds on and are ready to cede control over areas they now decide on nationally. These decisions could be taken quickly but they do not need to be taken overnight or over a weekend as in the financial crisis. Decision-makers can take some time to figure out the technical details as long as the general course is clear soon.

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Friedrichstraße 180
D – 10117 Berlin
Tel.: +49 (0)30 259219-339

Online: delorscentre.eu
E-Mail: info@delorscentre.eu
Bluesky: delorsberlin.bsky.social