HEINRICH BÖLL STIFTUNG
EUROPE

E-PAPER

Discussion Paper
Budgeting for Security?
Assessing EU funding instruments for defence

BY ANTON MÖLLER AND GEORG MCCUTCHEON

A publication edited by the Heinrich Böll Foundation, May 2025

Budgeting for Security?
Assessing EU funding instruments for defence

By Anton Möller and Georg McCutcheon

Contents

Note: The authors would like to thank Vera Benatar, Roderick Kefferpütz, Lydia Kořinek, and Eva van de Rakt for their review and helpful comments, and Siri Krobjinski for providing valuable research assistance. Any remaining errors are the sole responsibility of the authors.

1. Introduction

In light of Russia's ongoing full-scale invasion of Ukraine and the uncertainty regarding the United States' role in the transatlantic security architecture, the European Union faces a perfect storm. It needs to be able to defend itself against potential Russian aggression independently of the US, but at the same time, it needs to foster economic competitiveness, expedite the twin transitions, accelerate the path to net-zero climate targets and advance social cohesion. This will require substantial investments, from military technology to reliable infrastructure, and societal resilience that far surpasses the fiscal space available both at the EU and Member State level. Therefore, a debate on the security architecture of Europe is always a debate on the European fiscal rules and funding mechanisms. At the same time, the European Union will not only need to find the money to address the many challenges it is facing externally, but will also have to ensure that funds are used efficiently and spark cooperation between Member States in a field that is considered largely a nation-state prerogative. As some defence experts argue,[1] the European Union, despite many efforts, has failed thus far to provide a convincing «sales pitch» to Member States for a deepened European integration in the field of defence and military cooperation. Here, we argue, the choice of financing tools matters.

The European Commission has proposed the ReArm Europe/Readiness 2030 package, with which it hopes to «mobilise close to EUR 800 billion for a safe and resilient Europe'.[2] Aside from leveraging private capital through the Savings and Investments Union or the European Investment Bank (EIB) respectively, and adding flexibility to the existing EU budget (that is to say: repurposing of cohesion funds), the central component of the proposal concerns public funding.

In this analysis, we discuss the proposals made by the European Commission from an economic perspective to understand if this package will be able to deliver in creating fiscal space, if it addresses the internal challenges in EU defence policy-making, and how it will affect the economic governance system of the EU.

1 Sophia Besch, «*EU defence industrial policy in a new era*», Heinrich-Böll-Stiftung, 2025

2 European Commission, «*Press statement by President von der Leyen on the defence package*», Press statement, March 4, 2025; European Commission, «*Proposal for a Council Regulation establishing the Security Action for Europe (SAFE) through the reinforcement of European defence industry Instrument*», March 19, 2025

2. Outline of the European Commission's proposal for defence investment

The Commission's strategy to mobilise funding is twofold. First, President von der Leyen has announced that she invites a coordinated request by Member States to activate the national escape clause within the Stability and Growth Pact (SGP), limited to increased defence spending over four years from 2025 onwards. Specifically, an additional 1.5% of GDP in defence spending (compared to the net expenditure path calculated in the national medium-term fiscal-structural plans and relative to the reference year 2021) would not count towards national balance sheets. In practice, this allows Member States to either deviate from the net expenditure path and potentially record a deficit exceeding 3% of GDP without triggering an Excessive Deficit Procedure (EDP) or – if they are already under an EDP – to depart from the corrective path as a result of such increased defence expenditure. Accordingly, both the debt sustainability safeguard and the deficit resilience safeguard – designed to ensure debt levels above 60% of GDP are on a downward path and structural deficits do not exceed 1.5% of GDP, respectively – have been suspended. The Commission estimates that – provided Member States can actually spend an extra 1.5% of GDP on average over four years on defence – this move would free up fiscal space at the national level of close to EUR 650 billion that would be otherwise unattainable because of the EU's fiscal rules.

Second, ReArm Europe contains a proposal for a EUR 150 billion loan facility – Security Action for Europe (SAFE) – funded through EU borrowing, backed by the EU budget and, more specifically, the headroom between the own resources ceiling and the funds actually required for expenses under the current Multiannual Financial Framework (MFF).[3] Importantly, these funds would be disbursed to Member States as back-to-back loans under the condition that they are used for pan-European defence projects, such as joint procurement (preferably in Europe) of air defence, artillery, missiles, anti-drone systems and more. The package – designed in a way that allows for implementation through qualified majority vote rather than unanimity[4] – marks a significant step in delivering concrete policy proposals following various impromptu summits over the past months.

3 European Commission, «*NextGeneration EU*», n.d.

4 Paul Dermine, «*Funding Europe's Defence*», Verfassungsblog, March 5, 2025

3. Assessment of the ReArm Europe/ Readiness 2030 package

3.1 Fiscal rules and national escape clause

In the proposal, the European Commission suggests making use of the national escape clause in the Stability and Growth Pact and encourages all Member States to utilise this in a coordinated manner. By and large, this would allow all Member States to increase their defence spending by running a higher deficit. Whereas most Member States have expressed their need for higher defence spending, at the time of writing, only 12 Member States had formally requested the activation of the national escape clause. The decision to increase national debt for defence spending ultimately remains with the Member States and is constrained by the debt sustainability of national budgets.[5] Crucially, the plan does not mean that European fiscal rules don't matter anymore. Rather, Member States are allowed to deviate from their medium-term plans or debt reduction pathways specifically for higher defence spending, if fiscal sustainability is not threatened.

Striking a balance between fiscal stability and increased defence spending will be a crucial task, especially given that defence procurements do not usually fare well in their growth effects.[6] Several critics have pointed out that the current scope based on the Classification on the Functions of Government II (COFOG II) definition of defence will not allow for the implementation of expenditure that builds on a broader concept of security.[7] This could potentially undermine debt sustainability in Europe. Research has shown that underinvestment in climate change mitigation and adaption can weaken debt sustainability,[8] as does political instability that can result from a lack of democratic resilience, as recent developments leading to US bond market volatility have shown.[9] However, focusing on security-related investments with higher expected growth impact, for example in renewable energy markets, can achieve positive impacts on debt sustainability.

5 Lucas Guttenberg & Nils Redeker, «*How to defend Europe without risking another euro crisis*», Jacques Delors Centre, February 2, 2025

6 Bryan Rooney, Grant Johnson & Miranda Priebe, «*How Does Defense Spending Affect Economic Growth?*» Santa Monica, CA: Rand Cooperation, 2021

7 Sebastian Mang, «*Why Military Spending Alone Can't Save Europe*», Green European Journal, March 25, 2025; Philipp Rotmann & Abi Watson, «*Europe in the Turtle Trap: Defense Spending Alone Will Not Protect Us*», GPPi, March 14, 2025

8 Stavros A. Zenios, «*The risks from climate change to sovereign debt*», Climatic Change 172, 30 (2022)

9 Samantha Ajovalasit, Andrea Consiglio, Giovanni Pagliardi, & Stavros A. Zenios, «*Are bad governments a threat to sovereign defaults? The effects of political risk on debt sustainability*», Bruegel, January 21, 2025

The usage of national escape clauses will pose another challenge: time. Increase in defence spending will be allowed under the current medium-term expenditure plans that are set to four years. However, especially larger defence procurement processes will likely take longer than that and it can be expected that the need for defence spending will remain high in the foreseeable future, making an extension of the escape clause likely. This will further undermine the credibility of fiscal rules, as well as the fiscal sustainability of countries with high debt and deficit rates. Ultimately, the use of an emergency instrument will not create long-term legal certainty.

For these two reasons – ensuring long-term debt sustainability and predictable planning – a reopening of the European fiscal rules is crucial. This would allow the EU to avoid an endless series of emergencies that would undermine the credibility of the rules, and can help addressing the challenges that come with the narrow scope of this current proposal.

However, another key challenge will remain, notwithstanding the fiscal rules: European coordination in security and defence. While this part of the ReArm Europe/Readiness 2030 proposal will allow Member States to spend more, it only focuses on budgetary rules, not on procurement. It therefore offers no mechanism to coordinate spending, develop European institutional capacity in the defence sector or ensure that security is understood as a European public good.[10]

3.2 SAFE instrument

The European Commission has sought to address this challenge by complementing the activation of the national escape clause with the EUR 150 billion Security Action for Europe (SAFE) loan instrument. Upon closer inspection, however, it suffers from three apparent shortcomings.

The central issue concerns its lending structure. While further establishing the practice of EU debt issuance is a welcome initiative, the main selling point of this instrument is limited to lower borrowing costs – for selected EU Member States only. Rather than creating meaningful fiscal space at the EU or national level through additional funds, EU loans are relayed to Member States under the favourable borrowing conditions enjoyed by the EU on capital markets due to its ‹AAA› rating.[11] In other words, those Member States with a positive bond yield spread vis-á-vis the EU benefit from lower borrowing cost through the

10 Roel Beetsma, Marco Buti & Francesco Nicoli, «*The problem of missing European public goods from the rearm Europe plan*», Bruegel, March 18, 2025

11 Fitch Wire, «‹*ReArm Europe› Plan Would Lower EU's ‹AAA› Rating Headroom*», FitchRatings, March 13, 2025 instrument, as compared to borrowing themselves. For countries with very similar or even lower bond yields, however, the instrument's added value is limited (see figure 1).[12]

Further, these loans are counted as additional national debt on Member States' balance sheets. Consequentially, in order to retrieve them, many Member States will already require the new flexibility under the national escape clause, effectively signifying that most of the SAFE loans actually fall within the EUR 650 billion scope when calculating the impact of the package in mobilising funding. Given the «joint procurement conditionality» attached to those funds, many Member States will have to weigh more complex coordination efforts against marginally lower borrowing costs, reducing the incentive attached to the instrument.

This directly points towards the second issue at hand: the lack of practical guidance on how to integrate, standardise and «Europeanise» the EU's defence industrial policy. The new White Paper on European Defence Readiness 2030 lays the groundwork but the list of obstacles is long. A high degree of (strategic) fragmentation, different procurement priorities, diverging production standards and complex coordination requirements at the EU level, as well as concerns about knowledge-, skills-, and information-sharing, all stand in the way of a quick absorption of the EUR 150 billion by Member States.[13]

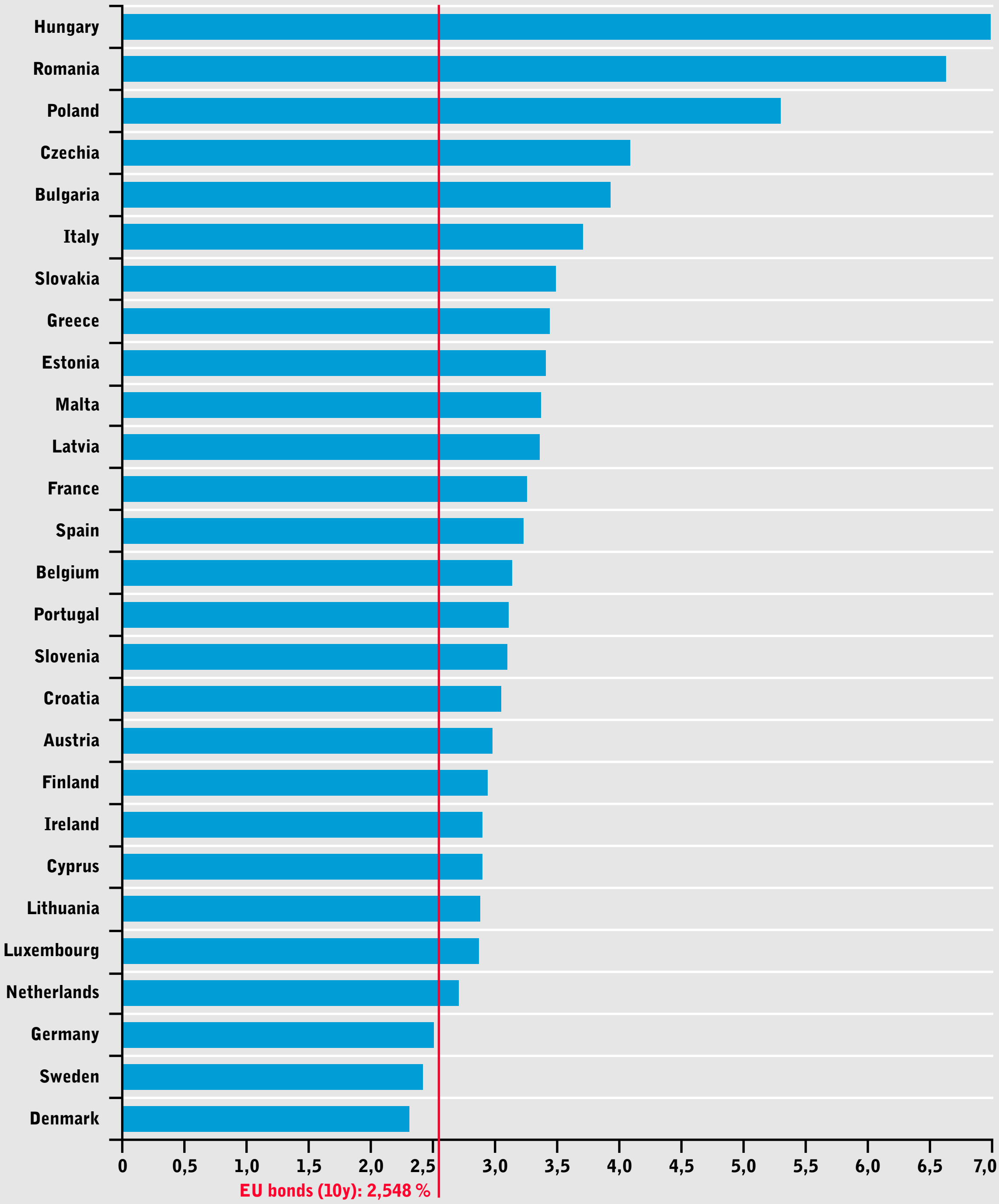
In addition, many Member States are wary of involving the EU in their defence industrial policy, as defence is a core national competence. While the Commission has demonstrated its willingness not to stand in the way of increased national defence expenditure and is increasing EU borrowing, the sensitivities and obstacles in the way of EU-wide coordination and joint procurement remain high. Without addressing the two shortcomings above, the SAFE instrument – despite its intentions – most likely remains unconvincing as a «sales pitch» to Member States that more Europe on defence is advantageous for them, and is thus not conducive to boosting political will for this objective.

A third crucial concern is the European Commission's use of Art. 122 TFEU as the legal basis for the SAFE instrument. If established under this Article as an emergency instrument, the European Parliament loses important monitoring and oversight competence over the disbursement of funds. As we will explore below, there are further considerations to be weighed against each other in this matter. However, parliamentary oversight is a critical factor, not only to ensure the input legitimacy of such an instrument but to safeguard efficient use of funds and hedge public spending against profit capture.

12 Lucas Guttenberg, [@lucasguttenberg.bsky.social/], «*Von der Leyen has just announced the Commission's «Rearm Europe» plan*», Bluesky, March 4, 2025; Luigi Scazzieri & Sander Tordoir, «*European common debt: Is defence different?*», Centre for European Reform, 2024

13 Besch, EU defence industrial policy

Figure 1: Interest rate spread for EU Member State bonds with 10-year maturity compared to EU bonds (in %)[14]



Source: Eurostat, TradingView, monthly averages for April 2025

14 Note: For non-Eurozone Member States, the comparison is complicated by the fact that issuance of bonds in their local currency carries higher risk-premiums. Should they decide to issue bonds denominated in EUR, their yield spread would likely decrease. As this decision cannot be presupposed at the time of writing, the data above is based on yields for bonds issued in local currency.

We argue that the shortcomings analysed above could be remedied through an EU-debt financed facility designed to disburse grants to Member States for defence spending. Such a proposal for the issuance of Eurobonds for defence comes with a number of questions that need ex-ante clarification. First and foremost, joint borrowing must not be an end in itself. Instead, we argue that such an instrument would address both the SAFE facility's shortcomings and the challenges associated with a temporary activation of the national escape clause identified above by actually increasing fiscal space and incentivising cooperation, integration and joint procurement. In other words, the Commission could use such an initiative by way of a «feasibility pilot» to properly demonstrate the – thus far largely theoretical – argument in favour of more Europe on defence. For this to be successful, the funds should only be used for coordinated spending and common procurement in priority areas defined by the European Council that strengthen the EU's defence industrial base.

Regarding the design and governance of such an instrument, four questions are key:

- Should all Member States be included?
- Are decisions made unanimously or through qualified majority?
- Could the instrument become part of the EU budget?
- How is the debt guaranteed and refinanced?

With these questions in mind, different options can be conceptualised. Drawing on Scazzieri and Tordoir, we explore two scenarios below, each with advantages and drawbacks.[15]

Scenario 1: A Union-wide approach – budget-backed joint borrowing

The first scenario broadly follows the design of the NextGenerationEU (NGEU) recovery package. Here, through unanimous approval by the European Council, the EU would issue bonds on capital markets on behalf of all Member States and the debt would be guaranteed and amortised by the EU budget, all but assuring the fund receives a «AAA» rating. If, as was the case with NGEU, the instrument is left outside of the Union's budget, this could severely limit parliamentary oversight. Bearing in mind that NGEU's off-budget structure was justified through its one-time, exceptional nature, it seems less clear that this should also apply in this case, as the EU's defence readiness is a long-term project. Crucially, this would require a reinterpretation of Article 41(2) (TEU), which currently prohibits expenditure with military or defence implications to be financed by the bloc's budget. Furthermore, depending on the volume of issued debt, a unanimous amendment to the EU own resources ceiling for gross national income-based contributions by Member States might become necessary, and therewith, the need for approval by national parliaments. Additionally, the

15 Scazzieri & Tordoir, European common debt: Is defence different?

search for new EU own resources has hit a roadblock. As things stand, debt servicing obligations for NGEU loans alone will reach approximately 20% of the current budget. An honest discussion on extending the scope of current revenue streams is therefore urgently warranted, especially in the case of further EU borrowing for defence.

Scenario 2: A coalition of the willing – flexible intergovernmental financing

There is, however, growing scepticism about the EU's ability to ramp up support for Ukraine and strengthen its defence, considering the veto powers of pro-Moscow governments such as in Hungary or Slovakia. As a result, pragmatic solutions such as intergovernmental «coalitions of the willing» are in high demand. Given the high-stakes nature of deterring Russian aggression, there may be no alternative but to circumvent Hungary's veto. To address this, grants could only be made available to EU Member States that are part of such a coalition of the willing. Such pooling would ensure that the coalition's EU members are able to contribute financially to the endeavour and the funds cannot be blocked by so-called «spoiler» states. The participating Member States would have to trigger enhanced cooperation for this and – crucially – introduce qualified majority voting on matters considering the instrument, so as to hedge its operability against others joining at a later date. This has far-reaching implications for the possibility to integrate the funding mechanism into the EU budget. To be sure, anchoring the instrument within the budget would ensure vital democratic oversight by the European Parliament. It is highly contested, however, whether a debt-financed vehicle guaranteed by the bloc's budget could legally be established through enhanced cooperation by qualified majority and integrated into the MFF, not to mention the difficulties surrounding Article 41(2) (TEU).[16] As such, it seems all but impossible for now that the incurred debt could be guaranteed by the EU budget in this scenario. Instead, following the pandemic-era SURE instrument, for example, the debt would have to be backed by voluntary contributions from participating Member States. The downside of this is that such guarantees are recorded as additional national debt. In light of the Commission's revised stance on the national escape clause, however, this may prove less of a problem for the time being. Theoretically, this structure would lend itself to participation by non-EU countries that are part of a coalition of the willing, thereby potentially increasing its effectiveness. The downside would be that external participation would most likely stand in the way of budgetary control and disbursement oversight by the European Parliament, undermining its democratic character and input legitimacy. Policy-makers should carefully weigh the benefits and downsides of the respective options against each other.

16 Silvia Merler & Francesco Nicoli, «*Beyond the Veto of the EU Recovery Fund*», Verfassungsblog, November 27, 2020; Martin Nettesheim, «*Keine Verstärkte Zusammenarbeit zu Lasten aller*», Verfassungsblog, November 20, 2020

3.3 Increased budget flexibility and repurposing cohesion funding

With regards to President von der Leyen's proposition for added flexibility in the MFF and repurposing of existing financing instruments within the EU's budget, there is little clarity as to what this will entail. However, the idea to channel cohesion funding into defence spending has been floated before and appears set to become a cornerstone of this objective.[17] To be sure, this comes with its own set of challenges. From a legal perspective, Article 41(2) (TEU) currently prohibits operational expenditure for measures with military or defence implications to come out of the EU's budget.[18] Secondly, whereas cohesion funding follows the objective to reduce economic, social and territorial disparities among EU Member States, and therefore prioritises less developed countries and regions, efficient and effective defence spending cannot follow the same logic – setting up difficult distributional conflicts. In other words, the key consideration when building an ammunitions factory, for example, especially in the context of a more integrated European industry, should be the locational advantage for efficient production, often held by economically stronger regions and therefore at odds with the goal of EU cohesion policy to align living conditions across the continent.

3.4 European Investment Bank

Lastly, the proposal to utilise the EIB to raise defence spending enjoys widespread support among EU leaders.[19] Leveraging private investment to facilitate arms companies' access to capital through the EIB is not uncontroversial, however. For one, the EIB would be required to change its lending practices, as it is currently prohibited from financing pure military projects. Secondly, a core asset of the EIB is its ‹AAA› credit rating. Pivoting to include large-scale financing of purely military projects and production could put this rating in jeopardy.[20] This would endanger the EIB's role as a key player in mobilising investment for the green transition to net-zero emissions by 2050 – an objective that, as we have argued, is directly related to European security and should not be deprioritised. In order to safeguard the green transition and hedge ourselves against the fallacy of rearming while leaving the EU exposed to threats that military force cannot guard against, it is

17 Paola Tamma, «*Brussels to free up billions of euros for defence and security from EU budget*», Financial Times, November 12, 2024; European Commission, «*Letter by President von der Leyen on defence to the European Council ahead of its meeting on Thursday, 6 March 2025*», Press Release, March 4, 2025

18 Jana Puglierin, «*Strenghtening the EU's Global Capacity to Act*», Heinrich-Böll-Stiftung, 2024

19 Jan Strupczewski, «*EU countries call for European Investment Bank to push into defence funding*», Reuters, January 31, 2025

20 Aurélie Pugnet, «*EIB to up defence investment to €2bn this year*», Euractiv, January 30, 2025 essential that we do not lose sight of the multitude of overlapping challenges.[21] With that in mind, a specialised ‹Rearmament Bank› could address the specific financing needs in the sector better without competing with other investment priorities in the European Union.[22]

21 Rotmann & Watson, Europe in the Turtle Trap

22 General Sir Nick Carter, Guy de Selliers & Edward Lucas «*Letter: Europe needs a rearmament bank to boost defence spending*», Financial Times, January 15, 2025

4. Considerations on competition and profit

With its ReArm Europe/Readiness 2030 package, the European Commission seeks to respond to the changing security needs of the European Union. Our analysis finds that the package runs the risk of not addressing a core issue of European defence policy, namely the lack of coordination amongst Member States. Similarly, we demonstrate that the added fiscal space delivered by the package is limited. To address this, an EU debt-financed instrument to disburse grants to Member States – either to the EU 27 and guaranteed by the EU's budget, or limited to a coalition of the willing but backed by national voluntary contributions – could increase the uptake of joint initiatives. Furthermore, utilising the national escape clause (i.e. an exemption of the European fiscal rules) could undermine their credibility, making a more structural and sustainable reform of fiscal rules advisable.

To ensure that increased spending – especially if debt-financed – is put to good use, a wider conceptualisation of security should be considered. This will make it possible to address other threats to European and human security – from democratic resilience to climate security – as well as the inclusion of investments with higher expected returns for European economies and societies. Whereas there are interlinkages between the different challenges the European Union is facing, increased defence spending should be considered additional – making the development of new, EU own resources in the longer term a necessity, as debt-financed instruments will not provide long-term funding. In this context, it is also important to note that recent findings from the Kiel Institute for the World Economy suggest that ambitious climate policies, in particular limiting the use of Russian oil, have a quantifiable security dividend.[23]

Moreover, the focus on financing raises several dilemmas that warrant consideration. First, the Europeanisation of the defence sector has led to market consolidation in the past.[24] Excluding foreign suppliers could exaggerate this trend. Expanding on the efforts of the Defence Industry Reinforcement through common Procurement Act (EDIRPA) and its successor, the European Defence Industry Programme (EDIP), future discussions need to address potentially conflicting objectives of efficiency gains through joint procurement of standardised goods, on the one hand, and maintaining supply-side competition on the other. Simply put: while standardised equipment allows for interoperability and cheaper economies of scale for buyers, this should not lead to over-reliance on a limited number of producers.

23 Timothé Beaufils, Michael Jakob, Matthias Kalkuhl, Philipp M. Richter, Daniel Spiro, Lennart Stern & Joschka Wanner, «*The Security Dividend of Climate Policy*», Policy Brief No. 187, Kiel Institute for the World Economy, 2025

24 Mitja Kleczka, Caroline Buts & Marc Jegers, «*Six decades of consolidation in the European defence industry (1960-2022)*», The Economics of Peace and Security Journal, 18(2), 2023

Second, the demand surge for defence goods has already led to a rally in profitability for European defence contractors and their shareholders.[25] Major institutional investors hold substantial stakes in European defence companies and, as a result, benefit directly from the rising public demand for defence goods. Given their high return expectations, raising equity through private investors can put pressure on companies to increase prices or repurchase shares to maximise shareholder profits. Since EU governments are the main buyers of military equipment, this represents an inefficient use of public funds. To ensure efficient use of the increased defence budgets, policy-makers need to address the risk of profit capture in the sector. One potential solution could be providing public equity to defence contractors. As Kaczmarczyk and Krebs point out in their analysis on how to finance the energy grid expansion in Germany, public equity in highly concentrated sectors can lead to significant efficiency gains.[26] Other measures could include identifying and utilising effective steering effects of joint public procurement, transparency, and parliamentary oversight over the disbursement of funds.

25 Jacopo Barigazzi, «*European defense companies are making a lot of money – and that's a problem*», Politico, October 30, 2024

26 Patrick Kaczmarczyk & Tom Krebs, «*Finanzierungsoptionen für den Stromnetzausbau und ihre Auswirkungen auf die Netzentgelte*», IMK Study Nr. 98, 2025

5. Policy recommendations

To address the challenges outlined above, the European Union should:

- Start a structured revision of the Stability and Growth Pact. The Commission's proposal to suspend parts of the freshly reformed fiscal rules shows that the guiding principles for such reform must be twofold. They must provide longer-term planning certainty of necessary investments in Europe's security, including green investments and investment in democratic resilience, while remaining flexible enough to allow for emergency measures in times of crisis. Here, we expect a changing political landscape in Europe, especially as the SGP has become a constraining factor to the implementation of Germany's constitutional amendments to allow for higher defence spending and the creation of a EUR-500-billion off-budget fund.[27] The European Commission should capitalise on this window of opportunity for future-proofing its fiscal framework.
- Focus on investments that both strengthen human security and enhance debt sustainability by allowing for investments with higher fiscal multipliers, and align with social and decarbonisation efforts of the EU.
- Incentivise European cooperation by developing debt-financed funding tools to disburse grants for coordinated spending and common procurement, and ensure parliamentary oversight.
- Design mechanisms to counteract profit capture in the European defence sector and ensure efficient use of public funds. This could, for example, entail mobilising equity through public capital. Additionally, procurement policy that is adapted to this new reality must not only be designed appropriately to ensure transparency, but the responsible agency must be adequately staffed and funded. Lastly, profit rates require constant monitoring and policy-makers should explore the viability of regulating a baseline profit rate. Here, the United Kingdom's Single Source Regulations Office (SSRO) could offer valuable insight into best practices.

27 Armin Steinbach & Jeromin Zettelmeyer, «*Germany's fiscal rules dilemma*», Bruegel, April 24, 2025

The authors

Anton Möller is a political economist and Head of the Green Economic and Social Policy programme of the Heinrich-Böll-Stiftung EU.

Georg McCutcheon is a political economist and EU Policy Advisor at the Heinrich-Böll-Stiftung.

Imprint

Publisher: Heinrich Böll Foundation e.V., Schumannstrasse 8, 10117 Berlin
Contact: Georg McCutcheon, EU & North America Division **E** *mccutcheon@boell.de*

Proof reading: Chris Meikle
Place of publication: *www.boell.de*
Publication date: May 2025