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DILEMMAS FOR THE EU IN DEFICIT-FINANCING OF DEFENCE EXPENDITURE AND MAINTENANCE OF FISCAL DISCIPLINE

LUCIO PENCH

The European Union is grappling with the challenge of increasing defence expenditure while maintaining fiscal discipline under the Stability and Growth Pact (SGP). The European Commission has proposed activating the national escape clause available under the SGP to accommodate defence spending without triggering the excessive deficit procedure (EDP). However, the scope and enforcement of this measure remain uncertain.

A proposed 1.5 percent of GDP cap on extra fiscal flexibility is legally questionable and unlikely to be enforced. While low-debt countries do not require the clause due to existing flexibility, highly indebted nations may find it insufficient in the face of rising debt costs. The escape clause may also serve as a backdoor for European Central Bank interventions under the Transmission Protection Instrument, which requires compliance with EU fiscal rules.

The Commission has also proposed the Security Action for Europe (SAFE) funding mechanism, a €150 billion loan programme to finance national defence investments. SAFE relies on national borrowing and follows the model of the SURE (Support to mitigate Unemployment Risks in an Emergency) facility, put in place during the COVID-19 pandemic. However, SAFE's limited scale and dependence on national fiscal capacities mean it falls short of the collective security funding approach advocated by economists.

Meanwhile, Germany's decision to reform its constitutional debt brake marks a major departure from its traditional fiscal policies. The reform establishes a permanent 'defence golden rule,' exempting military spending from borrowing limits, alongside a €10 trillion infrastructure fund. Although this move does not endanger Germany's fiscal sustainability, it undermines EU-wide fiscal coordination and conflicts with the SGP. This could weaken the European Central Bank's position in future market interventions. Given these challenges, discussions on a new EU fiscal framework are necessary to ensure fiscal flexibility while maintaining debt sustainability.

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1 Introduction

Europe's plan to accelerate its 'defence transition', in response to the Russian military threat and the turn of the United States away from Europe, risks a clash with the European Union's fiscal discipline requirements, as redefined by the reform of EU fiscal rules finalised in April 2024. The tension has been brought to a head by the European Commission's presentation, under the heading of ReArm Europe plan, in mid-March 2025 of two proposals that recognise the need for deficit-financing of a rapid increase in defence expenditure, while seeking to preserve the fragile consensus on the respective roles of the EU and its member states on fiscal matters underpinning the reform of the EU fiscal rules. The first proposal would allow recourse to the flexibility within the Stability and Pact (SGP; European Commission, 2025), specifically its escape clause. The second involves the creation by the Commission of a new EU financial instrument that will provide loans to EU countries for defence investments¹.

However, this attempt to adapt the EU framework to the security emergency has arguably been sidelined by a structural policy shift in Germany. The incoming German government has secured agreement on a radical overhaul of the fiscal rules embedded in Germany's constitution, known as its 'debt brake', to allow extra borrowing for defence expenditure (in addition to enabling a one-off infrastructure spending package worth 10 percent of GDP)². Responses to this have focused on the macroeconomic and geopolitical effects, both domestically and internationally, that could arise from increases in German deficit spending. But the reform of Germany's debt brake raises significant questions about the changes it portends in terms of the overall design of the fiscal framework, both from a single-country and an EU-wide perspective.

In this paper, we assess the implications of the recourse to the escape clauses of the SGP, including the possible consequences, intended and unintended, that this could have for the EU framework. We also assess the potential impact of the new EU loan instrument for defence, and examine whether Germany's overhaul of its national fiscal rules undermines the EU's overarching fiscal-coordination principle.

2 The Stability and Growth Pact escape clauses in theory and practice

2.1 Recourse to the escape clauses: an exercise in constrained flexibility

Building on the Maastricht Treaty's ban on "excessive deficits" and its injunction to regard national economic policies as "a matter of common concern", the Stability and Growth Pact (SGP) consists of a system of fiscal rules meant to constrain countries' deficit levels and debt trajectories.

¹ See European Commission press release of 19 May 2025, 'Questions and answers on ReArm Europe Plan/Readiness 2030', https://ec.europa.eu/commission/presscorner/detail/en/qanda_25_790.

² Tamsin Paternoster, 'Germany's upper house clears historic defence spending bill', *Euronews*, 21 March 2025, <https://www.euronews.com/2025/03/21/germanys-upper-house-clears-historic-defence-spending-bill>.

The reform of the SGP completed in April 2024 codified certain provisions on flexibility to deal with emergencies, collectively known as escape clauses³, under which EU countries can be given some leeway to deviate temporarily from normal fiscal plans. There are two forms of escape clause: a ‘general escape clause’ that can be activated in response to an EU or euro-area deep recession, and a ‘national escape clause’, under which a country can be given more flexibility to respond to a country-specific temporary exogenous shock. Apart from this difference, the formulations of the two escape clauses closely mirror each other.

In both cases, special provisions apply to countries subject to an excessive deficit procedure (EDP), reflecting the need to ensure the continuity of EDPs even in emergencies. For countries under an EDP, the activation of the escape clauses coincides with the possibility of adopting a revised EDP recommendation to accommodate the measures being taken in response to the emergency. This essentially means postponing the deadline for the correction of the excessive deficit by one year, with the possibility of further extensions⁴. See the tables in the annex for details of the two escape clauses, including references to relevant legal provisions.

A common condition for the activation of the escape clauses is that the resulting deviation from the adjustment path that a country was supposed to follow (ie as per its existing medium-term structural fiscal plan (MTFSP) or the existing EDP recommendation), should “*not endanger [fiscal] sustainability in the medium term*”. This condition was introduced in 2011⁵ but has never been given an operational formulation. In particular, dangers for sustainability were not taken into consideration when the

³ Before the 2024 reform, the SGP did not mention escape clauses. The provisions that became progressively known as escape clauses concerned: i) under the so-called preventive arm of the Pact, the possibility of allowing a temporary departure from the adjustment path towards the medium-term objective of close-to-balance-or in surplus in case of “*an unusual event outside the control of the Member State concerned which has a major impact on the financial position of the general government or in periods of severe economic downturn for the euro area or the Union as a whole*” (Regulation 1466/97, Art. 2); ii) under the so-called corrective arm of the Pact (EDP), the possibility of revising the EDP recommendation (irrespective of the action taken by the Member State concerned in response to the existing recommendation) in cases of “*unexpected adverse economic events with major unfavourable consequences for government finances occur[ring] after the adoption of the [EDP] recommendation (notice)*” provided that “*effective action has been taken*” or in case of “*a severe economic downturn in the euro area or the Union as a whole*” (Regulation 1467/97 Art. 3[5] [Art. 5[2]]); see also European Commission, 2019). While largely reproducing this language and maintaining the difference between countries subject to the EDP and the others, the reform of the SGP has formally introduced (and clarified the distinction between) general and national escape clauses and has specified the process for their activation, including the time limits that should apply.

⁴ While the two clauses differ in terms of the type of emergency triggering their activation, the revision of the EDP recommendation follows exactly the same rules, with one exception: in the case of activation of the general escape clause an extension of the deadline for corrective the excessive deficit can be granted irrespective of whether or not the concerned country is assessed to have taken “*effective action*” in response to the existing recommendation, ie to have delivered the prescribed adjustment (presumably net of the measures necessitated by the emergency). However, activation of the national escape clause does not release the concerned country from the same assessment of effective action, with a negative assessment implying that the extension of the deadline would be granted together with a ‘stepping up’ of the procedure, which for euro-area countries in principle entails the imposition of sanctions.

⁵ As part of the so-called Six-Pack SGP reform. See European Commission memo of 12 December 2011, ‘EU Economic governance “Six-Pack” enters into force’, https://ec.europa.eu/commission/presscorner/detail/en/memo_11_898.

general escape clause was invoked in response to the COVID-19 crisis. Then, all EU countries, irrespective of their very different sustainability risk profiles, were effectively allowed to ignore the fiscal adjustment paths that would have been normally prescribed by the rules.

The activation of the escape clauses requires a Council of the EU decision based on a Commission recommendation (preceded, in the case of the national escape clause by a request from the concerned country). Decisions also specify the periods during which escape clauses can apply, during which countries are allowed to deviate from their adjustment paths: one year for the general escape clause, but determined on a case-by-case basis for the national escape clause. Extension of durations is possible, but is subject to the same formal procedure and, as a rule, is for one year each time.

These strict procedural requirements were introduced when the SGP was reformed in April 2024. They reflect the uneasiness at the time of EU countries, notably Germany, about a perceived risk that the Commission applied the general escape clause overly permissively during the COVID-19 pandemic and its aftermath – there was in effect an unprecedented suspension of the EU fiscal rules from 2020 to 2024.

The extent of the deviation allowed by the escape clauses is not specified. However, at least for the national escape clause, an implicit limit applies in terms of scope⁶: as the clause is intended to deal with a specific set of ‘exceptional circumstances’, it follows that any deviation must be linked directly to those exceptional circumstances, and should reflect the costs of the measures needed to respond to them.

However, a newly introduced provision apparently contradicts the possibility of setting limits on the escape clause. The new provision stipulates, without conditions, that, for the period during which an escape clause applies, deviations are not taken into account for the purpose of assessing compliance with the rules. More precisely, deviations from the adjustment path in the existing MTFSP are not recorded in the ‘control account’, which measures the deviations from the adjustment path cumulated over the life of the plan. This is important because, under the SGP, if deviations cumulated in the account over the duration of the MTFSP exceed a certain limit, the country concerned (if its government debt exceeds 60 percent of GDP) should be in principle become subject to the EDP, even if its deficit does not exceed 3 percent of GDP. Following the April 2024 reform, the activation of the escape clause suspends the long-standing presumption that an EDP will be opened automatically if there is a breach of the 3 percent of GDP deficit threshold.

⁶ This limit was well understood to apply to the “unusual event” provisions, which represent the antecedent of the national escape clause before the reform of 2024 (see note 1). The scope of these provisions was characterised by Commission (European Commission 2019) in the following terms: “the additional spending should be directly linked to the unusual event; deviations in that regard can be allowed on a temporary basis only; the allowed deviations should only reflect the additional costs compared with the previous year (“incremental costs”), to the extent that the additional expenditures required to tackle the unusual event affect the structural effort and be net of any targeted contribution from relevant EU-funds; the burden of proof rests on the Member State requesting the deviation, which should substantiate its request with detailed information, while the Commission retains the right to make its own assessment about the exact figures to be taken into account.”

While insisting on time limits for the escape clauses, the updated rules remain silent on what happens after those limits expire. In particular, it is not specified whether a new MTFSP should be presented or the existing MTFSP revised – the latter option implying a degree of catching up with the overall fiscal effort originally envisaged. The silence could be explained by the implicit assumption that the circumstances triggering the activation of the escape clause should be temporary, and therefore the measures needed to respond to them should be equally temporary. The expiry of the escape clause would then be expected to coincide with an ‘automatic’ return of the fiscal position to return to its pre-crisis level.

2.2 Implementing the national escape clause: possible (un)intended consequences for the EU fiscal framework

The escape clause rules are arguably not well-suited to Europe’s current security emergency. Application of the general escape clause, which some countries might have welcomed as providing greater leeway for budgetary expansion, is excluded because the conditions for its activation – a severe economic downturn in the EU or the euro area as a whole – are not met. However, nor do the circumstances of the current security emergency really correspond to those for which the national escape clause was conceived, ie a genuinely temporary exogenous shock, such as the aftermath of a natural disaster. By contrast, evidence of the current emergency situation has been growing for some time and the situation is expected to persist for the foreseeable future.

The Commission proposals, specified in its mid-March communication on accommodating increased defence expenditure under the SGP rules (European Commission, 2025; Box 1), which corresponds to the main pillar of the ReArm Europe plan, can be seen as an attempt to deploy the maximum fiscal flexibility consistent with public debt sustainability, as redefined by and placed at the centre of the reform of the SGP.

Reflecting the prevailingly trend nature of sustainability, the reform does not seek to impose the achievement of a certain debt level, or even a certain reduction in it, by a certain point in time. Instead, it focuses on achievement within a certain time frame (corresponding to the period covered by MTFSPs) of a fiscal position (defined in term of primary balance) that ensures that the debt ratio is declining, with a sufficient safety margin. Recourse to the escape clause would likely imply a postponement of the achievement of that objective. However, assuming that deviations from adjustment paths are limited in time and size, the trend decline in debt would not be compromised.

More in general, the restrictions placed on the recourse to the escape clauses (section 2.1) could be seen as ensuring that permanent increases in military expenditure are met not with recourse to debt, but through revenue increases (or cuts to other expenditure), in line with the standard prescription of economic theory that aims at minimising the efficiency losses from tax collection (‘tax smoothing’).

The Commission proposals however raise a number of other issues.

The explicit invitation for all EU countries to request the application of the clause seems meant to mitigate the potential stigma attached to the procedural requirement that countries should make individual requests, subject to vetting by the Commission and endorsement by the Council.

At the same time, the Commission's anticipation of a four-year extension for the escape clause (see Box 1) probably goes beyond what the drafters of the SGP had in mind (and is reminiscent of the protracted suspension of the SGP linked to the COVID-19 pandemic and its aftermath).

Possibly in the light of the experience of COVID-19, the Commission seems keen to put limits on the extent of the deviation allowed by the recourse to the escape clause: not only is the leeway envisaged to cover only defence expenditure, but its size would be limited to 1.5 percent of GDP (Box 1).

However, the legal basis for capping the size of the deviation is unclear⁷. The new SGP provision on the 'freezing' of the control account during the application of the escape clauses would actually seem to exclude pre-determined limits on the size of the deviations, or, more accurately, to prevent its enforcement via the EDP, which relies on the operation of the control account (section 2.1).

Interpreting the 1.5 percent GDP limit as an operationalisation of the hitherto disregarded fiscal sustainability condition is also unconvincing: sustainability risk is inherently associated with the fiscal situations of each EU country and cannot be reasonably captured by a one-size-fits-all limit on the debt increase. These weaknesses suggest that the cap on extra spending may suffer from a time-inconsistency problem: the Commission is understandably keen to proclaim the cap *ex ante*, but may be reluctant, if not unable, to enforce it *ex post*.

The 1.5 percent GDP figure was first mentioned publicly by European Commission President Ursula von der Leyen in connection with the more eye-catching €650 billion amount of extra 'fiscal space' that application of the escape clauses would create over four years⁸. However, the link between the flexibility in principle allowed within EU rules and actual extra spending by EU countries is less straightforward than these announcements suggest.

⁷ By contrast, contrary to Guttenberg and Redeker (2025), it seems clear enough that extra expenditure unrelated to defence would be outside of the scope the national escape clause and hence not allowed (section 2.1).

⁸ European Commission statement of 14 February 2025, 'Speech by President von der Leyen at the Munich Security Conference 2025', https://ec.europa.eu/commission/presscorner/detail/en/speech_25_516. €650 billion would actually fall short of 1.5 percent of GDP over a period of four years, though the figures were quoted in the same statement. The discrepancy is presumably due to the assumption that increase in defence expenditure would take place only gradually.

Box 1: The implementation of the national escape clause in the context of the European security emergency

In its communication on accommodating increasing defence expenditure within the SGP rules (European Commission, 2025), the Commission states that the security emergency facing Europe in the wake of Russia's war against Ukraine constitutes "*exceptional circumstances*," thus allowing the national escape clause to be triggered. In the light of the EU-wide nature of the emergency, the Commission invited all EU countries to request the application of the clause, in line with the procedure envisaged for its activation, with the aim of a joint examination and adoption by the Council before the summer (July 2025).

The following specifications deserve particular attention:

- For the duration of the application of the clause, the Commission envisages four years, starting from 2025. This would be in line with the default duration of the MTFSPs, allowing for common expiry of the clause and the plans, and the presentation of new plans for the subsequent period. The possibility of a further extension, to be decided before the expiry date, is not excluded.
- On the extent of the allowed deviation, the Commission envisages two limits:
 - I. Scope-wise, in line with the nature of "*exceptional circumstances*", the deviation should be limited to the increase in total defence expenditure (ie including both current and capital expenditure), measured according to the Eurostat's functional classification of government expenditure (COFOG), with 2021 (considered as the year preceding the start of emergency giving rise to the activation of the clause) serving as the benchmark year;
 - II. Size-wise, the deviation should be capped at 1.5 percent of GDP, relative to the adjustment path prescribed according to the existing MTFSP (excluding from the path the impact of the additional 'numerical safeguards', ie taking only into account the adjustment necessary to satisfy the debt-sustainability requirements). Deviations in excess of the cap would be "*subject to the normal assessment of compliance*", ie treated as deviations from the adjustment paths that EU countries are obliged to follow. The imposition of the 1.5 percent cap on the allowed deviation is justified as "*necessary to ensure that fiscal sustainability is not endangered*".

The logic of EU fiscal rules is essentially proscriptive: they exclude certain fiscal trajectories but otherwise refrain from prescribing the content of national fiscal programmes (Carnot, 2015). The same logic applies to the escape clauses: it is for national governments to decide whether or not to use the extra room for budgetary manoeuvre. In relation to defence spending, the Commission seems keen for countries to do so, at least within limits, but other factors than the availability of the escape clause may be driving the fiscal behaviour of EU countries.

The Commission announcements may therefore actually obscure the real meaning of the activation of the escape clause. In particular:

- Even from the perspective of EU fiscal rules, low-debt countries do not actually need recourse to the escape clause if they want to carry out more deficit spending within the 3 percent deficit threshold. This is because, following the reform of the SGP, and in contrast with the previous, more invasive, set of rules, low-debt countries are subject to hardly any policy interference from the EU as long they keep their deficits and debts below 3 percent and 60 percent of GDP respectively⁹. In fact, the escape clause would not even be needed in order to be able to breach the 3 percent of GDP deficit threshold without being subjected to an EDP, because for countries with debt ratios below 60 percent of GDP, the opening of an EDP is not automatic but conditional on the result of an examination of “*relevant factors*”, which include “*the increase of government investment in defence*”¹⁰.
- The escape clause is therefore relevant mainly to high-debt countries. This includes countries that have managed to avoid an EDP by bringing their deficit below 3 percent of GDP (in particular, Spain, Portugal and Greece) and the countries that were placed under an EDP in early 2025 (in particular, Italy, France and Belgium)¹¹. From the point of view of these countries, however, the availability of the national escape clause may not be enough. They would have likely preferred the activation of the general rather the national escape clause, on grounds of less stigma and (arguably) greater budgetary leeway. Above all, however, these countries may be disappointed with the limited common EU borrowing in the ReArm Europe proposal to finance extra defence spending, particularly in comparison with the management of the COVID-19 crisis (see section 3). Without common EU borrowing, high-debt countries may fear that using the extra fiscal space created by the escape clause could result in negative reactions from the markets concerned with the debt sustainability of those countries. Or, perhaps more accurately, they may not be willing to incur the extra risk associated with additional borrowing, however limited, for the sake of increasing defence expenditure, which, if not outright unpopular, does not offer obvious electoral dividends (Dorn *et al*, 2024).
- The escape clause could however make a material difference for high-debt countries in at least one important respect: should for any reason debt-rollover risk materialise with sudden spikes in risk premia, it would facilitate the activation by the European Central Bank of the Transmission Protection Instrument (TPI), involving potentially unlimited purchases of the affected country’s government bonds. The first and arguably most important eligibility criterion for the TPI is

⁹ Member States with a debt ratio below 60 are equally obliged to present medium-term fiscal structural plans to the Commission and have it endorsed by the Council. However, since, outside of the case of breaching the 3 percent of GDP deficit limit, the enforcement of the adjustment path in the plans relies on the EDP for breach of the debt criterion, which is applicable only to Member States with a debt ratio above 60, low-debt Member States are largely protected from EU interference with their budgetary policies.

¹⁰ Regulation (EC)1467/1997 (as amended by Regulation (EU) 2024/1263), Art. 2(3e).

¹¹ See Council of the EU press release of 21 January 2025, ‘Stability and growth pact: Council adopts recommendations to countries under excessive deficit procedure’, <https://www.consilium.europa.eu/en/press/press-releases/2025/01/21/stability-and-growth-pact-council-adopts-recommendations-to-countries-under-excessive-deficit-procedure/>.

“compliance with the EU fiscal framework”¹², with compliance defined by reference to the steps taken by the Commission and the Council under the EDP¹³.

The most important element in Commission’s proposal may therefore not be the application of the escape clause *per se*, but the signal it gives that the Commission is unlikely to enforce the EU fiscal rules by escalating the EDP for as long as the defence-related emergency persists, thereby paving the way for possible market intervention by the ECB.

3) The likely limited impact of the new EU debt instrument

While the firepower of the ReArm Europe package relies mainly on extra expenditure decided on, carried out and financed by individual countries, the package does include an element of EU-level resource pooling, the proposed Security Action for Europe (SAFE) financial instrument. This would provide EU countries with loans up to a total of €150 billion to be spent on defence product and services as specified in national plans (European Defence Industry Investment Plans) according to common criteria – most importantly, joint procurement and exclusive sourcing from European product and service providers¹⁴ (European Commission and High Representative, 2025).

Reliance on loans is meant to exclude the provision of grants to EU countries, with the common debt to be serviced out of the EU budget, as was done with the post-pandemic Recovery and Resilience Fund (RRF). There will therefore be no *“defence RRF”* (Scazzieri and Tordoir, 2024). This option may have been excluded because it would have struggled to clear the legal-institutional hurdles the RRF had to overcome¹⁵. Financing military expenditure out of grants from the EU budget might also have increased the demand for conditions to be attached to the spending by the beneficiary member state, which might have been difficult to reconcile with national prerogatives when it comes to defence.

Financing additional defence expenditure by borrowing from the EU (as opposed to spending EU grants) implies a corresponding increase in national budget deficits, which recourse to the escape clause is meant to accommodate under the EU fiscal rules. To pursue the comparison with the EU response to the COVID-19 crisis, the model for the SAFE instrument appears to be Support to mitigate Unemployment Risks in an Emergency (SURE) facility, the EU loan facility introduced soon after the outbreak of the pandemic to support countries in rolling out job-retention schemes¹⁶. Compared to a

¹² See European Central Bank press release of 21 July 2022, ‘The Transmission Protection Instrument’, <https://www.ecb.europa.eu/press/pr/date/2022/html/ecb.pr220721~973e6e7273.en.html>.

¹³ Strictly speaking, the Member States subject to EDP could face a stepping up of the procedure, and hence a potential loss of eligibility for the TPI, should they deviate from the adjustment path because of measures unrelated to the response to the crisis, ie, not defence-related (or, if one accepts the validity of the cap on the 1.5 percent of GDP cap on extra defence expenditure, should they exceed the cap). However, experience suggests the presence of a “no-escalation bias” on the part of the Commission and the Council when faced with such a case, which the linkage with the TPI is likely to exacerbate, resulting in EDP escalation being seen as a ‘nuclear option’ (Pench [2024]).

¹⁴ In addition to the EU Member States, eligible providers include EEA/EFTA members and Ukraine.

¹⁵ Hurdles included the critical step of amending the EU Own Resources Decision, which requires unanimity of, and ratification by, EU countries (Grund and Steinbach, 2023).

¹⁶ While not implying outlays for the EU budget, a facility such as SURE for assistance to countries requires a guarantee in the EU budget of the contingent liabilities it creates, ie the risk that a state does not repay the loan received. The guarantee

‘defence RRF’, the creation of a ‘defence SURE’ is clearly less politically and institutionally fraught, as back-to-back lending belongs to the standard toolkit of EU financial instruments and the creation of the new facility would not require unanimity. Beyond the requirements for joint procurement involving at least two EU countries, and for purchasing from EU-based suppliers, national governments appear to face relatively few constraints under SAFE on the allocation of defence investments¹⁷. The ringfencing of the funds to defence expenditure implies that the long-standing legal objection based on the EU Treaty ban on financing of ‘pure’ defence spending by the EU budget should be considered overcome or, perhaps more accurately, overtaken by events¹⁸.

Concerns about stigma associated with requests for the national escape clause would presumably extend to requests for financial assistance from SAFE. While in the case of the escape clause, stigma may be avoided by generalised recourse to it, including by countries that effectively do not need it, only a subset of countries can be conceivably interested in accessing a ‘defence-SURE’: those that cannot access the financial markets on more favourable terms than the Commission. In addition, the limited size of the proposed facility relative to the challenge posed by re-armament, argues for limiting access it – or alternatively, increasing its size¹⁹. A larger facility than the €150 billion currently proposed would however likely increase opposition from the EU countries that do not expect to benefit from it.

The size and the nature of the proposed common borrowing fall short of the European public good (EPG) approach that some economists²⁰ advocate in order to respond to the defence emergency. The implicit interest subsidy from EU borrowing terms, together with the joint procurement and common priority areas for investment, are the only EPG elements that can be clearly recognised in SAFE. It remains to be seen whether, as in the case of the COVID-19 crisis, the first immediate steps

typically relies on the EU budget’s ‘headroom’, ie the difference between the maximum resources that the Commission can ask EU countries to contribute to the budget in a given year (own resources ceiling) and the funding that the EU requires to cover the expenses foreseen in the budget in the same year (Pekanov and Url, 2024). In the case of SURE, concerns about the availability of headroom in the EU budget demanded recourse to a complex system of voluntary guarantees from EU countries, with the EU budget providing only residual backing, namely, after the exhaustion of the member states’ guarantee buffer (ECA, 2022). This concern was removed by the adoption of the new Multiannual Financial Framework 2021-2027, which substantially increased the EU budget’s ‘headroom’.

¹⁷ European Commission and High Representative (2025; the ‘defence white paper’) listed seven “*priority capability areas*” for allocating expenditure financed by SAFE: air and missile defence, artillery systems, missiles and ammunition, drones and anti-drone systems, strategic enablers and critical infrastructure protection, military mobility, cyber, artificial intelligence and electronic warfare.

¹⁸ Art. 41(2) TEU bans the use of the EU budget for “*expenditure on operations having military or defence implications*”. This is the reason, for example, why the financing of the operations of the European Defence Agency is outside of the EU budget (although it includes contributions from the EU budget). The SAFE proposal confirms a trend of interpreting of the Treaty ban on EU financing of defence expenditure in increasingly flexible ways (Rodrigues, 2024).

¹⁹ In evaluating the adequacy of the size of the SAFE instrument one should note that military investment on equipment typically covers about between one fifth and one third of total defence expenditure (Wolff and Mejino-Lopez 2024). Note however, that the notion of investment retained in the SAFE proposal seems to be more encompassing than the common definition of equipment, including, eg ammunition.

²⁰ Roel Beetsma, Marco Buti and Francesco Nicoli, ‘The case for a European Defence Compact’, *First Glance*, 23 January 2025, Bruegel, <https://www.bruegel.org/first-glance/case-european-defence-compact>.

represented by the recourse to the SGP escape clauses and the provision of loans to countries to deal with the emergency, will be followed by a more substantial pooling of resources at EU level²¹.

4 The reform of the German debt brake: breaking with national fiscal orthodoxy and EU fiscal rules

Notwithstanding its significance, the Commission's ReArm Europe package has been overshadowed by decisions taken in Germany to overhaul the constitutional fiscal rule known as the 'debt brake'. In particular, this reform will do away with the borrowing constraint on defence-related spending (and includes a one-off spending package on infrastructure of the order of 10 percent of GDP). Germany's upper house, the Bundesrat, finalised on 21 March the change to spending rules.

The reform does not take the form of the introduction of an escape clause, which by definition entails an only temporary suspension of the normal functioning of the existing rules. Instead, it replaces the existing rules, specifically, by modifying permanently the upper limit on Germany's deficit. The new limit would be essentially determined by the amount of defence expenditure (in excess of 1 percent of GDP)²².

The new rule can be characterised as a 'defence golden rule', by analogy to the golden rule of investment, according to which government should borrow only to finance public investment (Balassone and Franco, 2000). The main argument for such rules is that they allow the cost of durables (in this case, military equipment) to be spread over time, rather than having to be financed from current revenues. This may be particularly important in a political context in which a tax-financed increase in defence expenditure might not receive the necessary political support.

A pitfall of golden rules, however, is that they create incentives to reclassify expenditure as investment to benefit from the same preferential treatment. The exemption of some spending (defence spending in this case) from borrowing limits might also reduce the scrutiny of the costs and benefits of each project, a problem that may be particularly acute with defence expenditure. An additional shortcoming of the proposed 'defence golden rule', unlike the traditional golden rule, is that it fails to distinguish between current and capital expenditure. Nor is a defence golden rule supported by the argument that the assets financed by borrowing will contribute to the productive potential of the economy and will thus, at least to some extent, pay for themselves.

Fundamentally, insofar as the expected increase in defence expenditure is of a permanent nature, financing by borrowing appears justified only by political-economy considerations. Activation of an escape clause, as proposed by the Commission, would appear overall a better solution

²¹ Roel Beetsma, Marco Buti and Francesco Nicoli, 'The problem of missing European public goods from the ReArm Europe plan', *First Glance*, 18 March 2025, Bruegel, <https://www.bruegel.org/first-glance/problem-missing-european-public-goods-rearm-europe-plan>.

²² More accurately, the new deficit upper limit would be equal to the amount of defence expenditure minus 0.65 percent of GDP because the federal government and the state governments are allowed to run a deficit of up to 0.35 percent of GDP (Zettelmeyer, 2025).

(notwithstanding the stretching of the national escape clause beyond its original purpose of accommodating a strictly temporary and exogenous shock).

The purpose of the EU fiscal framework, however, is not to prescribe optimal rules of fiscal behaviour to EU countries, but to avoid serious negative spillovers from national fiscal behaviour for the whole EU – or more accurately, the euro area. EU fiscal rules are essentially meant to avoid potentially unsustainable public-debt trajectories, because of their serious implications for the area-wide financial and monetary stability.

From the perspective of the EU fiscal framework, Germany's debt brake reform can be assessed legally or economically. Legally speaking, the reform of the debt brake appears to ignore the main provision of the SGP – that countries with a debt ratio in excess of 60 percent of GDP should aim at a medium-term fiscal position that ensures that debt is put on a “*plausibly downward path*”²³. In the immediate future, the activation of the escape clause will spare the Commission and the Council the embarrassment of having to consider the rejection of Germany's fiscal plan for violation of the SGP rules or the opening of an EDP for Germany. Insistence by the Commission on the 1.5 percent of GDP cap on the allowed deviation (section 2.2) may however already prove problematic. Since the reform of the debt brake is meant to apply permanently, the Commission and the Council will find it increasingly difficult to ignore its apparent inconsistency with the rules of the SGP.

Economically, there is little reason to fear that the debt brake reform will result in an unsustainable debt trajectory. An upper limit to deficits implies debt converging to a stable level, which, for plausible values of the deficit allowed by the new rules, would be between 90 percent and 100 percent of GDP (Zettelmeyer, 2025). Moreover, convergence to a stable level would be a gradual process, with debt remaining below 80 percent of GDP within the horizon considered for assessing debt sustainability under the SGP. Including the infrastructure fund would raise these levels by about 10 percent of GDP but, in light of Germany's long track record of fiscal prudence, would not change the overall conclusion that Germany can comfortably afford the deficit spending allowed by the relaxation of the debt brake.

These conflicting conclusions point to the dilemma raised by the overhaul of German fiscal rules: what Germany proposes to do does not undermine its stability-oriented domestic fiscal regime, but upends the rule-based system that underpins fiscal policy coordination in the euro area. Some critics of the SGP (eg Wyplosz, 2019) may take this as a vindication of the contention that fiscal rules in a monetary union cannot be imposed from above, but need to be homegrown, with a robust no-bail-out rule acting as the necessary incentive for fiscal discipline at national level. In the present situation, however, the prospect of devolution of the SGP is accompanied by the risk of fiscal dominance: open defiance of the

²³ Even more obvious is the proposed reform's disregard of the debt brake for the additional numerical safeguards prescribing (for countries not subject to the EDP) a minimum decline of one percent of GDP in the debt ratio already before reaching the medium-term objective and the eventual achievement of a structural budgetary balance no lower than 1.5 percent of GDP, irrespective of satisfying the required trend decline in debt.

SGP construction by Germany would increase the pressure on the European Central Bank to intervene in the markets, should EU countries with less fiscal space face difficulties in refinancing their debts.

Could the recently closed economic governance review be re-opened without putting into question the main elements of the April 2024 SGP reform? Before the reform was agreed, Pénch (2023) advocated an approach closer to the philosophy of its origin, more focused on a debt-sustainability criterion defined in line with the Commission classification of countries as low, medium or high risk, based on debt-sustainability analysis. Essentially, countries' fiscal plans would be deemed in line with the SGP if they would not lead, once implemented, to a debt sustainability classification of high risk. However, as the negotiations moved toward a close, the contours of the reform actually shifted in the opposite direction, through the introduction of numerical requirements going beyond ensuring a trend decline in high debts. Ironically, in retrospect, Germany was the main advocate of these economically unfounded requirements.

Getting to such an alternative approach focused on debt sustainability would not be straightforward, not least because the current Commission classification of sustainability risk remains based on by debt thresholds reflecting the 60 percent of GDP reference value²⁴. However, an approach defined by the aim of debt de-risking, operationalised through a commonly agreed state-of-the-art methodology, may still hold the key to a more economically rational fiscal framework for the euro area.

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²⁴ In particular, in line with the risk classification of the Commission (European Commission, 2023) upwards debt trajectories implying a breach of the debt thresholds of 60 percent of GDP and 90 percent of GDP would not be consistent with classifications as low risk or medium-risk, respectively. Countries with a debt ratio in excess of 90 percent of GDP would be able to avoid a high-risk classification if the debt trajectory pointed downwards.

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ANNEX

Table 1: The national escape clause of the Stability and Growth Pact

	Condition for activation	Activation procedure	Extent of the deviation	Duration and possible extension	Aftermath
Member states not subject to EDP (default)	<i>“Exceptional circumstances outside the control of the Member State hav[ing] a major impact on the public finances of the Member State concerned provided that [the] deviation does not endanger [fiscal] sustainability in the medium term” (Reg. (EU) 2024/1264 Art. 26(1))</i>	Council recommendation [Art. 121(4) TFEU]] on recommendation by the Commission based on its analysis... following <i>“request from Member State”</i> (Reg. 2024/1264 Art. 26(1))	Unspecified [corresponding to the costs of the measures needed to respond to the exceptional circumstances] Deviations from adjustment path in medium-term fiscal structural plan (MTFSP) <i>“not recorded in the control account”</i> (Reg. 2024/1264 Art. 22(7)) Possibility of not opening EDP even for breach of 3% deficit threshold (Reg. (EC) 1467/97 Art. 2(5))	<i>“Time limit specified by the Council”</i> Extensions possible [more than once] for <i>“an additional period of up to one year”</i> each time (Reg. 2024/1264 (EU) Art. 26(1))	New adjustment path according to revised or new MTFSP (?)
Member states subject to EDP		Revised EDP recommendation (Art. 126(7)) TFEU) / notice (Art. 126(9) TFEU) (Reg. (EC) 1467/97 Art. 3(6) and Art. 5(2)) provided <i>“effective action”</i> taken [excluding effects of response to exceptional circumstances]	Specified by revised EDP recommendation (Art. 126(7)) TFEU (Art. 126(9)) TFEU) / notice [excluding effects of response to exceptional circumstances]	Deadline for correction of excessive deficit extended by one year <i>“as a rule”</i> (Reg. (EC) 1467/97 Art. 3(6) and Art. 5(2)) [Repeatedly revised recommendations possible]	Adjustment path according to latest applicable EDP recommendation (Art. 126(7)) TFEU)/ notice (Art. 126(9) TFEU)

Table 2: The general escape clause of the Stability and Growth Pact

	Condition for activation	Activation procedure	Extent of the deviation	Duration and possible extension	Aftermath
Member states not subject to EDP (default)	<i>“Severe economic downturn in the euro area or the Union as a whole, provided that [the deviation] does not endanger fiscal sustainability over the medium term”</i> (Reg. [EU] 2024/1264 Art. 25(1))	Council recommendation [Art. 121(4) TFEU]] on recommendation by the Commission based on its analysis... (Reg. 2024/1264 Art. 25(1))	Unspecified Deviations from adjustment path in medium-term fiscal structural plan (MTFSP) <i>“not recorded in the control account”</i> (Reg. 2024/1264 Art. 22(7)) Possibility of not opening EDP even for breach of 3% deficit threshold (Reg. (EC) 1467/97 Art. 2(5))	<i>“One-year limit specified by the Council”</i> Extensions possible (more than once) for <i>“an additional period of up to one year”</i> each time (Reg. 2024/1264 [EU] Art. 25(1))	New adjustment path according to revised or new MTFSP (?)
Member states subject to EDP		Revised EDP recommendation (Art. 126(7)) TFEU) / notice (Art. 126(9) TFEU) (Reg. (EC) 1467/97 Art. 3(6) and Art. 5(2))	Specified by revised EDP recommendation (Art. 126(7)) TFEU (Art. 126(9)) TFEU) / notice	Deadline for correction of excessive deficit extended by one year <i>“as a rule”</i> (Reg. (EC) 1467/97 Art. 3(6) and Art. 5(2)) [Repeatedly revised recommendations possible]	Adjustment path according to latest applicable EDP recommendation (Art. 126(7)) TFEU)/ notice (Art. 126(9) TFEU)



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