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Spending more on defence without damaging social spending – time for a coalition of the borrowing?

NATO's commitment to sharply increase spending on defence and security presents a daunting fiscal challenge for many European governments. Iain Begg asks whether a "coalition of the borrowing" that enables countries to raise debt collectively could provide the solution.

A few weeks ago, **NATO countries** agreed to invest substantially more in their defence and security. But they have no idea how they are to meet the challenging target of raising military spending to 3.5% of GDP by 2035, topped up by other security spending to take the aggregate to 5%. The three options for funding this increase are both obvious and profoundly challenging: raise taxes, cut other public expenditure or increase public borrowing. The coalition of the willing is, in practice, a coalition of the constrained.

Meanwhile, most of these same countries already face tough fiscal challenges, including obligations to spend more on **climate change** and to accommodate demographic pressures. Of the 23 EU members in NATO, over half exceed the EU's debt benchmark of 60% of GDP, as do the UK, Canada and the US. Public debt currently exceeds 100% of GDP in four of NATO's largest members, including the US; only Turkey and Poland of the countries with sizeable militaries have much fiscal "space".

Unless growth defies current projections by rising substantially, spending on defence and security, especially within Europe, may require politically difficult decisions on cutting healthcare and welfare spending. A partial solution would be better welfare to work programmes that boost employment rates and thus the tax base. But additional money will have to be found in many countries to forestall fiscal crises.

A coalition of the borrowing?

A credible answer would be to raise debt collectively, with all of the increased funding hypothecated towards higher defence and security spending: a “coalition of the borrowing”. The case for resorting to this form of debt funding for defence is compelling. Threats to peace carry huge risks of chaos and disorder, so that investment now to reduce risks of war in the future could be the best insurance policy.

Broadly, there are three ways of doing so, all of which could be agreed and implemented rapidly. The first would be a common “NATO” bond issuance for defence. There would be delicate questions to resolve about a potential guarantor (NATO, with or without a direct US commitment? The EU?), though with next to no expectation that the guarantees would be called, and about how to account for the loans in national systems.

The EU successfully adopted such an approach in response to the pandemic by borrowing to fund its €800 billion “**Next Generation EU**” programme, guaranteed collectively by the European Union’s members through the EU budget. Another EU example was the (also successful) **€100 billion “SURE”** initiative in 2020 which enabled states to borrow from the Commission to finance furlough schemes.

Such loans are known as “back-to-back” because the Commission borrows then lends on to the member state, enabling the latter to benefit from the Commission’s favourable terms of borrowing. This works because the EU is assessed as having a safe “AAA” score by ratings agencies. The member state is liable for repayment to the Commission, then back to financial markets, with the EU budget as a guarantor against the (unlikely) contingent liability of a default.

The EU is doing so again with its **Security Action for Europe** (SAFE) initiative to support defence procurement. Established in May this year, SAFE enables the European Commission to borrow up to €150 billion to be distributed to member states in the form of long-term loans for joint defence procurement. The facility will be open to the EFTA countries, and those with whom the EU has a security and defence partnership, now including the UK.

A pan-European defence fund would be less fiscally demanding than Next Generation EU because the latter was a mix of grants (requiring eventual repayment from future EU budgets) and loans to be repaid, via the Commission, by member states. However, the great advantage of the loan component was to enable the more fiscally vulnerable member states to borrow at much more favourable rates.

Collective action

Second, as advocated by researchers at Bruegel, a **European Defence Mechanism** (EDM) could be set up to support defence procurement. They propose that participating countries be shareholders and guarantors. This would be along the lines of the **European Stability Mechanism**, established in

2012 by an inter-governmental treaty, outside the EU legal order, which provides macroeconomic support for countries facing a liquidity crisis. An EDM could extend to the UK, Canada and Turkey.

If a collective response is not possible, the third option would be an annual national bond issuance in each country, amounting to, say, 1% of GDP. If implemented simultaneously in each country (outside its current fiscal rules), this approach could limit the exposure of any single country to bond market pressures.

Poland, already with the highest spending on defence of all NATO members at 4% (the three Baltic states are next in the rankings), uses an extra-budgetary Armed Forces Support Fund, managed by the state-owned National Development Bank. As well as amending its strict “debt brake”, Germany has resorted to a special fund, the *Sondervermögen*. In the UK case, the lessons of the 1914-18 War could be relearned by issuing war loans and calling on patriotic citizens to contribute.

Clearly, there would be many details to settle. For example, a challenge for EU NATO members is reconciling more on defence with their national fiscal rules and, especially for Eurozone members, the parallel EU rules. But in early July, the EU’s **Council of Ministers** approved the applications of fifteen member states to be allowed to borrow up to 1.5% of GDP more, provided it was exclusively for defence. The fifteen include Germany, once Europe’s most prominent fiscal hawk. In response to concerns about countries favouring national defence contractors, leading to inefficiencies, Bruegel’s EDM proposal spells out how the mechanism would ensure open procurement procedures.

However, it is the principles that matter. Collective action has worked in the past and was, by design, a feature of the response to the 2008 global financial crisis. Had one country acted alone, it was in danger of being penalised by the markets as an outlier. It worked then to recapitalise the banks and is exactly the response needed now to prevent war by preparing for war, without breaking Europe’s social contracts or causing a fiscal crisis. Could a *coalition of the borrowing* be today’s solution?

*Note: This article gives the views of the author, not the position of EUROPP – European Politics and Policy or the London School of Economics. Featured image credit: **Prime Minister Keir Starmer meets US President Donald Trump** by **Number 10**, CC BY-NC-ND 4.0*



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