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NOTE

From:	General Secretariat of the Council
To:	Financial Counsellors - ECOFIN preparation
Subject:	Increased defence expenditure and its treatment in the new Economic Governance Framework - Issues note for the ECOFIN Council

Delegations will find attached the Presidency issues note "Increased Defence Expenditure and its Treatment in the New Economic Governance Framework" revised by the Presidency. This document will serve as the basis for discussion during the March ECOFIN Council breakfast.

Increased defence expenditure and its treatment in the new Economic Governance Framework

Issues note for the Ecofin Council

Introduction

The European Union's economic governance framework (EGF), as amended in 2024, includes essential provisions regarding the build-up of defence capabilities and the increase in government investment in defence. It was negotiated in the aftermath of Russia's second invasion of Ukraine in 2022 and, therefore, takes into account the security challenges posed by Russia to Europe.

Given the mounting pressure on Europe, an upward revision of NATO's 2% GDP defence expenditure floor (which currently aligns with the EU average) appears increasingly likely. The fiscal framework is well-prepared for such an eventuality. Regulation 2024/1264 explicitly states that the Commission shall:

- "reflect, among others, the increase of government investment in defence (...)
- give due and express consideration to any other factors which, in the opinion of the Member State concerned, are relevant."

Moreover, Regulation (EU) 2024/1263 also contains a national escape clause (Article 26) that allows for a deviation from the endorsed net expenditure path in the event of "*exceptional circumstances outside the control of the Member State with a major impact on its public finances, provided that it does not endanger fiscal sustainability over the medium term*".

To achieve the objective of increasing military expenditure in Europe, it is essential to define both the scope and timeframe of the planned increase in defence investment/expenditure, while ensuring the credibility of the EU fiscal framework in preserving debt sustainability.

Thus far, due to the absence of a common interpretation of the recently amended EGF, a strict interpretation of "the increase of government investment in defence" prevailed. This interpretation has been limited to the physical delivery of military hardware while avoiding consideration of "any

other factors,” such as the recruitment of new soldiers, who are essential for the operation and maintenance of this new equipment.

To create favourable conditions for increased defence expenditure in Europe, three key issues require consideration.

Definition of government expenditure in defence

Fiscal notifications already account for military equipment expenditure and other investments in military infrastructure, as defined by the ESA. However, this remains a narrow classification, aligned with the definition of gross fixed capital formation. As a result, it excludes essential spending, such as personnel costs for soldiers and other expenditures related to defence production, including factories and dual-use infrastructure.

To address these needs, a broader scope of defence expenditure is required. Such an approach, based on the COFOG (Classification of the Functions of Government) defence category, would be fully consistent with EU rules.

Time relevant benchmark

The regulation 2024/1264 clearly specifies that the Commission may assess the increase of defence investment against the following criteria:

- “Union averages,
- medium-term trends or
- other relevant benchmarks”

The substantial build-up of defence capabilities began in 2022 following Russia’s aggression against Ukraine, although not uniformly across all EU member states. To facilitate higher defence expenditure across all EU countries while ensuring fairness for those that increased spending immediately after the invasion, 2021 could serve as a benchmark year when assessing relevant factors under regulation 2024/1264, in line with the concept of “other relevant benchmarks.”.

Time horizon for the increased government expenditure

Ramping up military production is a multi-year process, with contracts often extending for a decade or longer. When determining the appropriate timeframe for increased government expenditure, two

options could be considered: the Code of Conduct and/or the National Escape Clause (NEC). To preserve debt sustainability, the fiscal framework can help to transition to a higher level of defence spending, while permanently maintaining the high level of defence spending would eventually require a re-prioritisation of the national budgets by Member States.

Conclusions

European countries must invest more in defence to safeguard the security of Europe amid rising global threats. While leveraging the EGF to incentivise defence spending is not the sole solution, it is an essential tool. The immediate priority should be to enhance military spending and improve the predictability of Member States' budgetary policies. No changes to the EGF are required to meet these objectives. To that end, Ministers will be asked two questions.

Questions for discussion

- Do you support the COFOG category “defence” to cover not only military infrastructure investment and military hardware, but also spending on the recruitment of new soldiers and other expenditure due to increased defence related needs?
- Do you agree that permanent solutions as regards the timeframe are needed (i.e. up to 10 years to match the length of military contracts) or do you prefer a solution to accommodate the transition to higher defence spending? How do you see the link with fiscal sustainability in EU Member States?