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Debt Financing European Air Defence

Ukraine is not the only part of Europe vulnerable to missiles and air attacks (Dausend et al., 2024). Existing capabilities, in particular NATO's integrated air and missile defence systems (NATO, 2023), are insufficient to comprehensively protect European territory. Experience in both Ukraine and Israel shows that effective missile defence is actually feasible. Yet, air defence systems such as the US-made Patriot or the German Iris-T are expensive – one reason why European governments have not invested sufficiently.

EU debt outside of national fiscal rules would provide resources for the costly roll-out of the European public good air defence as a response to an imminent threat to European security. This act of mutual assistance would free national budgetary resources and provide long-term funding stability, thereby also helping to boost the domestic defence industry.[1] We discuss how such EU debt could be justified in EU law and concretely implemented.

Defence has typically been considered an area of purely national sovereignty with little willingness to advance integration due to differences in preferences. Defence and military capabilities are likened to core sovereignty issues and a country's ability to effectively exercise state power (Dobbs, 2014). This has led some national constitutional courts to identify defence as a core function of the nation state for its sovereignty. This would imply that transferring competence for defence to the EU could be unconstitutional and core defence capabilities would therefore have to remain under national control (German Federal Constitutional Court, 2009). The sensitivity of defence as an issue of national concern is further reflected in the very limited collaboration that defence has seen throughout the EU integration process. Accordingly, European Treaties flag defence and military issues (just like the Common Foreign and Security Policy more generally) as areas of national competence, where EU-based defence activities are limited in scope and constrained by unanimity voting.

Yet, Mérand and Angers (2014) highlight that European defence integration enjoys consistently high levels of public support. Genschel and Jachtenfuchs (2015) identify the increasing integration without federalisation of core state powers, including defence, in the EU. Graf (2020) demonstrates that strategic threat perceptions can impact public opinion on European defence cooperation and integration, e.g. the perception that Russia's military activities in Ukraine are a threat to Germany's security increases support for the creation of a common European army. Likewise, Burgoon et al. (2023) underline that crises relax the "constraining dissensus" in relation to defence integration. They find both cross-border support for European defence as well as converging preferences on the actual design of such policy. It is therefore perhaps no surprise that the somewhat ad hoc German proposal on air defence, the European Sky Shield Initiative (ESSI), put forward by Chancellor Scholz in August 2022, has rapidly been endorsed by 21 participating states, with Poland also considering taking part.

The initiative, however, has been criticised by France and others, in part because of its focus on US and Israeli defence companies providing central elements of the air defence systems.

Yet, if EU debt were additional, purchases from US companies would not crowd out European industrial development. Moreover, EU debt funding for air defence could include spending on the further development of European air defence industrial capacities, including the French/Italian SAMP-T systems, as highlighted by President Macron (2024). Moreover, while the debt financing is strictly limited in scope and quantity to European air defence (mainly for the legal reasons outlined below), the financial investments would also provide long-term funding that would ensure the necessary stability for effective industrial policy and fiscal forward guidance for the industry to

1 Since EU debt would be additional, i.e. outside of national fiscal rules and budget consolidations, increased spending in the short term would not come at the expense of defence industrial policy objectives. Germany, for example, bought Patriot systems in 2023 and 2024 for several billion euros. These purchases absorbed a significant part of a special €100 billion German defence fund (*Sondervermögen*). If EU funding were made available, freed-up fiscal resources could be focused on domestic and European military purchases – for example drones – including from European high-tech defence companies.

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enhance production capacities. The build-up of capacities of domestic defence companies in air defence is all the more important in order to have a diversity of systems rendering European air defence more resilient to possible disruptions from foreign suppliers.

Since air defence concerns Europe as a whole and not only the EU, an EU funding initiative should be open to European allies, including the United Kingdom and Norway, which are part of the same airspace that needs to be defended. While the EU borrowing mechanism that we propose would focus on EU procurement, non-EU allies could be associated with that mechanism.

ESSI and its proper governance design

Why air defence is a European public good

Defence is almost by definition a public good as states hold the monopoly on the use of force. What requires further justification is to what extent defence is a European public good. A European public good can be defined as a good not supplied at an adequate level without public intervention (Breton, 2024; Fuest & Pisani-Ferry, 2020), and which should be provided, at least partially, at the EU level to internalise externalities and reap benefits of scale, notwithstanding potential differences in national or local preferences (Claeys & Steinbach 2024). This definition from the fiscal federalism literature (Tiebout, 1956; Oates, 1972; Alesina et al., 2005) does not necessarily apply to all dimensions of defence to the same extent. In the EU, as well as in NATO, any national army provides a public good beyond its own security to some extent as it can be called up and contribute to collective defence via NATO Article 5 and Article 42(7) Treaty on European Union. This is a direct way of contributing to collective deterrence and thereby shows that national defence capacities are, at least to some extent, a European public good. As countries can, to a degree, count on assistance from others, there is an incentive to free ride on others' provisioning of military services.

An area with particularly strong scale effects and externalities is air defence. When it comes to threat detection, the more radar and other detection systems are interconnected and data shared, the easier it is to detect threats early on and the lower the investment needed for every individual country. For aircraft, cruise missiles and drones flying at low to medium altitude, countries of first entry should typically be the ones that neutralise the threat, thereby providing a public good to all countries further away that might have been targeted. Even for high-altitude ballistic missiles, the detection and provision of neutralisation can happen from countries other than the one targeted. For example, a ballistic missile threatening the Netherlands is unlikely to be intercepted only in the Netherlands. European air defence is therefore a particularly strong type of public good that few to no European countries could provide on their own. Scale economies and externalities thus offer a strong rationale for providing the public good at the European level rather than nationally. With fixed costs for building up air defence being significant, integrating national efforts into one unified approach can untap substantial saving potential.

At the same time, the Germany-led ESSI – while having been endorsed by 22 European countries – has been seen critically in France and Italy in particular. The criticisms concern the strategic level, questions of scale and availability as well as industrial policy questions (Arnold & Arnold, 2023). While preference heterogeneity exists at the European level, it is not impossible in the case of air defence to overcome some of the differences to provide the good at the EU level. At the strategic level, there is the worry that building up a strong air defence would upset the balance of power and deterrence between Russia and Europe, in particular as concerns high altitude deterrence such as the one provided through the Arrow 3 system. There is also fear that there is too much investment in air defence rather than in capacities for deep strikes. As concerns the questions of scale and availability, the reservation is that ESSI relies too strongly on US-based systems, in particular on the Patriot system, which creates strategic dependencies on the US and limits availability based on the production capacity of the US company Raytheon. Finally, the industrial policy worry is that European taxpayer money would boost US defence companies instead of advancing European systems from France and Italy, in particular SAMP-T.

Since the inception of ESSI, some convergence has been achieved on these three dimensions, and French President Emmanuel Macron has explicitly recognised the importance of ESSI for countries without nuclear deterrence (Federal Government, 2024). When it comes to the balance between deterrence and strike capabilities, there is a growing recognition that air defence cannot come at the expense of strike capabilities – while at the same time, the importance of air defence has been recognised for countries with limited nuclear deterrence. When it comes to strategic dependence, MDBA Germany is building a factory to produce Patriot missiles, but capacities might still be insufficient and dependencies exist. These drawbacks must, however, be balanced against the advantages of the availability of the US systems and their high performance. To make debt funding acceptable and ensure Europe's air defence industry strives, it will be important to strengthen the interoperability of systems and include SAMP-T systems, Iris-T as well as other European systems in the European funding efforts.

The adequate governance design for air defence as a European public good

Characterising air defence as a European public good does not necessarily imply that all its elements should be centralised at the EU level (Claeys & Steinbach, 2024). Rather, the EU legal and institutional framework offers a menu of design options that allow customising the governance of the public good guided by efficiency and trade-offs described above. One design option that accounts for policy preferences that are too diverse is the provision of "club goods" rather than EU27 provision of European public goods. The Treaties generally allow for the provision of "club goods" through "enhanced cooperation" and defence is a case in point (Fuest & Pisani-Ferry, 2019; Demertzis et al., 2018). One design option offering flexibility in governance would be the Permanent Structured Cooperation (PESCO). PESCO is an area of security and defence cooperation through the development of national contributions towards more defence capabilities in relation to development, research, acquisition and armaments.[2] Projects involving non-EU countries have also been pursued under the PESCO umbrella. PESCO could thus become the framework for some air defence equipment purchases and for enhancing R&D in air defence in collaboration, where applicable, with the European Defence Agency and the European Defence Fund.

ESSI is currently running outside of the EU as a Germany-led initiative among European countries that are also NATO members.[3] ESSI currently includes 21 states, of which 17 are EU members (Poland may soon join) while four are European allies (Norway, the UK, Switzerland, Turkey). The PESCO cooperation framework counts 26 EU member states. The PESCO framework provides sufficient flexibility for at least the 17 EU ESSI members to cooperate in PESCO projects. ESSI could become a new PESCO project, and those 17 EU countries (of the 26 PESCO members) supporting the project can agree on a "club good" based initiative of ESSI.[4]

The participating member states would agree among themselves on the arrangements for, and the scope of, their cooperation and the management of that project. Integrating non-European countries into ESSI is possible under the PESCO architecture, as it has already been practiced in the past by integrating the US and Canada into the PESCO Military Mobility project.[5]

The advantage of pursuing ESSI within PESCO is that a suitable institutional governance exists that could provide the basis for joint debt financing and could also be used for increasing cooperation in procurement as well as R&D. In particular, integrating ESSI into PESCO would allow the use of resources from the European Defence Agency (EDA), for example, to enhance the interoperability of different systems and invest in R&D, including the French and Italian air defence system.

Also, supplying air defence as a public good can be customised by its delivery in a central or decentral fashion. In our understanding, the EU would play no operational role in air defence, which would remain solely the competence of member states and the agreed NATO framework. Some elements, however, could be delivered at the EU level, such as defence procurement of air defence (e.g. joint large-scale purchases of military equipment). In a less ambitious approach, the purchases would still be done nationally but under a joint framework contract. Jointly issuing debt would not require the European Commission to decide on spending as this would remain in principle the responsibility of the member states, or, if centrally decided, subject to unanimity in the Council.

As joint procurement will create not only winners but possibly also some losers, such as incumbent industrial players who may lose their (national) market shares, it is important to consider political implications. Incumbent industrial players seek to retain their (national) market shares, but joint (rather than national) procurement and purchase of air defence armaments can revitalise competition, break up national markets and threaten national "champions" (Burgoon et al., 2023). Some regions may be adversely affected if the regional industry loses market shares. While some compensation mechanisms are politically advisable to strengthen the domestic defence industrial base (which would not benefit significantly from the US/Israel-oriented industry), the key point in our proposal is that the overall market size should increase more rapidly, making the joint debt issuances and joint procurement a positive sum game. With the larger spending, it should be possible to include TWISTER and SAMP-T in the ESSI purchases.

2 Article 42(6), 46 TEU and Protocol No 10 to the TEU.
3 Article 46 TEU.
4 Article 5 of Council Decision (CFSP) 2017/2315.
5 https://www.pesco.europa.eu/pressmedia/development-delivery-and-determination-pesco-forging-ahead

Debt financing ESSI

Economic rationale for EU debt funding

PESCO projects are generally financed by those countries participating in PESCO projects.[6] In the case of air defence, joint debt issuance could raise the resources to fund the member states spending on ESSI in the context of PESCO while also reserving some funds for centrally organised purchases and R&D. The idea would be to use EU debt as a mechanism to prevent the catastrophic event of a direct military threat from Russia (Wolff, 2020).

The economic rationale for debt funding air defence is straightforward: building the air defence systems represents a huge upfront investment cost. Once the system is in place, the operating costs are relatively small. The operation of the radar systems and sustaining the readiness is costly but nothing compared to the actual costs of putting up the systems. Large upfront investments should be funded by deficits for tax-smoothing arguments as well as for spreading costs over the periods during which systems will be used.

Legal implications of EU debt financing air defence

The legal implementation of exceptional debt financing ESSI is challenging but feasible. There is a general restriction for the EU budget to fund expenditure arising from operations having military or defence implications. However, our solution introduces EU borrowing "off-budget" and outside the regular EU budget (like with NextGenerationEU). Further guarantees to protect the (financial) interests of neutral states are possible.

With NextGenerationEU as the precedent of debt financing EU expenditure, there are several legal strings attached to repeating debt financing. A distinction must be made between *borrowing* for ESSI purposes and *spending* for ESSI activities. The central legal authority for the Commission to borrow on behalf of the EU is the Own Resources Decision (ORD) (Grund & Steinbach, 2023). The ORD requires both a unanimous Council decision that designates the main sources of EU financing and ratification by each member state. The ORD authorises borrowing and specifies how the borrowing proceeds are to be used. This implies that borrowing requires a new ORD and hence ratification by EU countries in line with domestic constitutions (as specified by Article 311 TFEU). The financial resources that the EU "borrows" under Article 311 TFEU and the ORD are externally assigned revenues just like under NGEU.

In turn, spending of the funds raised needs to have a distinct legal anchor, which, in the case of NGEU, was the emergency clause of the EU Treaties (Article 122 TFEU). This provision is also referred to as a "solidarity clause" and it justifies the financing of targeted and temporary economic measures in exceptional situations. The emergency clause requires linking the use of borrowed funds to addressing the "exceptional occurrence" within the meaning of Article 122 TFEU. Despite obvious differences with NGEU, the building up of an ESSI-based air defence can be likened with an emergency and solidarity situation under Article 122 TFEU, in which member states give mutual assistance to divert an immediate security threat.

The Russian attack on Ukraine was an unforeseen shock hitting and putting at risk the security of the EU and its member states. Even if the attack primarily aimed at a non-EU country, there is wide consensus that Russian territorial imperialism engenders a direct threat to EU security (Cavoli, 2024). The legal standard has been specified by the German Federal Constitutional Court (2022) requesting that debt financing be limited in duration, volume and substance. The last requirement entails linking the use of borrowed funds to addressing the "exceptional occurrence" within the meaning of Article 122 TFEU. This was key to the German Federal Constitutional Court (2022) ruling, which held that the relevant instrument "remains strictly limited to the historically exceptional case of 'support[ing] the recovery in the aftermath of the COVID-19 crisis'". It may well be argued that an assault in the immediate neighbourhood country of the EU by military means can be likened to a "historically exceptional case", which leads the ESSI project fortifying European defence to respond to this exceptional event. Even today, the direct threat of a Russian attack on EU territory is visible. Increased hybrid attacks and stray missiles reaching EU territory are among some of the numerous indicators of the immediacy of the threat.

Conclusions

The increased threat perception has shifted sentiment in Europe, and the building up of defence capabilities has increased in importance in many countries. Surveys also indicate that citizens want the European Union to play a larger role in defence (Bertelsmann Stiftung, 2024). It is therefore no surprise that the German initiative to build up a European air defence system, called ESSI, has been welcomed and endorsed by 22 European countries. Yet, France and Italy in particular have expressed reservations

6 Article 8(2) of Council Decision (CFSP) 2017/2315.

about the initiative, even though some strategic convergence has become visible in the course of 2023.

This article argues that joint EU debt funding would be appropriate to boost European air defence. Joint funding can be justified by the fact that air defence is a European public good with a lot of externalities and spillovers. Debt funding is appropriate since air defence system build-up requires high upfront costs. We have discussed the legal approaches to such debt funding following a model that is close to the post-COVID-19 NextGenerationEU recovery plan and find that such a legal construction is tenable.

Policymakers would be well advised to rapidly set up such a major EU debt programme to boost European security in a spirit of solidarity between European countries. This would free national fiscal resources for other urgently needed defence systems. They should further adjust ESSI to take into account justified industrial policy concerns and support the research and development for system interoperability and the enhancement of European technology in air defence. Finally, policymakers need to find ways to include non-EU ESSI members in the efforts. While most of the jointly issued EU debt would be dispersed to EU ESSI members to fund their purchases and could therefore be matched by non-EU ESSI members' domestic funding, adding equivalent national debt contributions of the respective ESSI countries to any joint purchases and joint R&D efforts would complement the approach. On the whole, EU debt would allow the advancement of European defence efforts in a highly threatening security environment. Joint EU debt funding would internalise the major security externalities of air defence, be treaty compatible and politically highly welcome – without hindering EU industrial policy objectives.

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