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The Economics of Security: Public Budget Constraints and Defence Spending in NATO Countries

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Abstract

This dissertation investigates the intricate relationship between public budget constraints and defence spending in NATO countries, focusing on the interplay between fiscal limitations and geopolitical security challenges. It traces the evolution of NATO's defence budgets from the Cold War to contemporary times, highlighting key historical moments, including the dissolution of the Soviet Union and the post-9/11 security environment. Special attention is given to the renewed pressure on NATO members, particularly European countries, to meet the 2% GDP defence spending target in the wake of Russia's invasion of Ukraine. NATO countries face the challenge of balancing military spending with crucial public services such as healthcare, education, and pensions, all within the constraints of rising public debt and fiscal deficits. This study combines theoretical perspectives and empirical data to analyse how NATO countries are balancing budgetary limitations and defence strategies. It evaluates defence spending trends before and after significant geopolitical events, emphasising the complex financial trade-offs that nations must navigate. Ultimately, this dissertation offers policy recommendations for achieving sustainable defence spending. It advocates for fiscal discipline while maintaining robust defence capabilities, addressing the need for a collective defence posture in a rapidly evolving global security environment. These insights aim to guide policymakers in balancing public budget constraints with the growing demand for military expenditure within NATO, ensuring that economic stability and national security can be maintained simultaneously.

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- ATMIS - African Union Transition Mission in Somalia
- CBO - Congressional Budget Office (United States of America)
- DOD - Department of Defense (United States of America)
- EFP - Enhanced Forward Presence
- EFP - European Peace Facility
- EU - European Union
- GDP - Gross Domestic Product
- G7 - Group of Seven
- ICC - International Criminal Court
- ICJ - International Court of Justice
- IFIs - Independent Fiscal Institutions
- IMF - International Monetary Fund
- INF - Intermediate-Range Nuclear Forces
- ISIS - Islamic State of Iraq and Syria
- KDP - Kurdish Democratic Party
- NATO - North Atlantic Treaty Organization
- OECD - Organisation for Economic Co-operation and Development
- OCHA - Office for the Coordination of Humanitarian Affairs (United Nations)
- R&D - Research and Development
- RSF - Rapid Support Forces
- UN - United Nations
- UNHCR - United Nations High Commissioner for Refugees
- US - United States
- WBG - World Bank Group

1. Introduction

We live in an era marked by numerous geopolitical challenges, where shifting power dynamics, regional conflicts, and the rise of new security threats constantly reshape the global landscape. From the resurgence of great power competition to the proliferation of hybrid warfare and non-state actors, nations today face a more complex security environment than ever before. Recent events—such as the ongoing conflict in Ukraine and the assertive actions of China and Iran—have heightened concerns about territorial integrity, regional stability, and global order. In response to these evolving threats, the countries belonging to the NATO alliance are under increasing pressure to adapt and ensure their collective defence capabilities are robust. However, the need for heightened defence preparedness comes at a time when many NATO allies are also facing significant fiscal challenges. The delicate balance between ensuring national security and managing public finances has thus become a critical issue for NATO members, shaping their defence strategies and budgetary decisions.

Defence spending plays a pivotal role in shaping national security strategies, especially within collective defence frameworks like NATO. As the world faces an increasingly complex and volatile geopolitical environment, the need for military investment has return to centre stage. Events such as the ongoing conflicts in Ukraine and the Middle East, as well as tensions in Central Africa and Southeast Asia, have revived concerns about territorial integrity, sovereignty, and the strength of collective defence. These concerns are not limited to NATO countries, but the alliance has been particularly focused on ensuring that its members are well-prepared to respond to emerging threats. However, the call for increased defence spending has come at a time when many NATO countries are facing significant fiscal challenges. These countries are grappling with competing demands for public spending, particularly in critical areas like healthcare, education, and social services, while also managing the broader economic effects of inflation, rising interest rates, and recovering from the economic disruptions of the COVID-19 pandemic. The significance of this issue is underscored by NATO's decision to formalise the 2% of GDP defence spending target at the 2014 Wales Summit. This target, set in response to growing security concerns, reflects NATO's collective commitment to maintaining robust defence capabilities in the face of evolving global threats. While the target is not legally binding, it serves as a political benchmark for member states to aspire toward. Despite this commitment, the path to achieving the 2% target has been fraught with difficulties for many NATO countries, highlighting that some members continue to struggle with balancing their defence priorities against domestic fiscal constraints.

This dissertation is motivated by the need to explore how NATO countries are reconciling the imperative for increased defence spending with the fiscal constraints that they face. This topic is highly relevant given the current global security environment, characterised by rising tensions between major powers, the emergence of non-state actors, and the proliferation of hybrid warfare tactics. Additionally, the economic realities faced by many NATO countries, ranging from high levels of public debt to economic slowdowns, make the question of how to fund defence without sacrificing other essential public services particularly pressing. The analysis undertaken in this dissertation seeks to contribute to the broader discourse on defence spending and fiscal policy by examining how NATO countries are addressing these challenges and what lessons can be drawn for future defence planning. The sources used in this dissertation include a combination of primary and secondary materials. Primary sources consist of official reports and statistical data from NATO, national governments, and international organisations such as the International Monetary Fund, the World Bank, and the Organisation for Economic Co-operation and Development. These sources provide up-to-date information on defence spending, budget allocations, and the economic pressures faced by NATO member states. Secondary sources include scholarly works on defence economics, public finance, and international relations theory, particularly alliance theory and burden-sharing in military alliances. Together, these sources offer a comprehensive view of how defence spending decisions are made within the context of fiscal constraints, and they provide a foundation for analysing the broader implications of these decisions for collective security within NATO.

The topic will be approached through a multi-faceted analytical framework. First, the historical context of defence spending within NATO will be explored, with a particular focus on the post-Cold War period, which saw significant reductions in military expenditures across the alliance. This will be followed by an examination of the renewed emphasis on defence investment in the aftermath of the Russian annexation of Crimea and the subsequent geopolitical shifts that have placed renewed pressure on NATO countries to meet their defence obligations. This analysis will be situated within the broader context of fiscal constraints, examining how economic factors such as inflation, interest rates, and public debt influence defence budgets. Furthermore, the concept of strategic autonomy within the European Union will be addressed, as it plays a critical role in the defence spending decisions of many NATO countries. The EU's aspirations for strategic autonomy, particularly in the defence sector, have been a driving force behind some countries' increased defence investments. However, this push for autonomy is complicated by the reliance of European NATO members on the United States for military support and security guarantees.

The rest of the dissertation is organised as follows. Chapter 2 offers a comprehensive literature review on defence spending within NATO countries, tracing its historical trajectory from the Cold War era's elevated military budgets to contemporary challenges. Chapter 3 introduces the central research question: How do NATO member states reconcile the need for increased defence spending with fiscal constraints in their national budgets, particularly in light of competing public sector demands such as healthcare and education? The research explores the implications of these budgetary tensions on collective security within the alliance, especially as geopolitical and demographic challenges intensify. Chapter 4 presents an in-depth analysis of the current geopolitical and macroeconomic environment, highlighting the challenges NATO countries face due to rising geopolitical tensions; it also introduces the concept of the Preparedness Index, an original tool designed to evaluate the readiness of NATO member states to increase public investments in defence in response to emerging security threats. Chapter 5 presents the findings of the analysis and offers policy recommendations for balancing increased defence spending with fiscal sustainability in NATO countries with a particular focus on European members. Chapter 6 presents the conclusions and final thoughts.

The findings of this dissertation reveal the economic complexities NATO countries face in sustaining defence spending amid fiscal constraints. Recent geopolitical events have catalysed increased defence expenditures among NATO members, with most now nearing the 2% GDP target. This prioritisation of defence underscores a strong commitment to collective security; however, it also exposes disparities in fiscal readiness, as some countries are better equipped to handle these financial demands due to more favourable economic conditions. Countries with high fiscal health and defence investment are well-positioned to sustain increased military spending, while others face constraints due to high debt levels or slower economic growth. The dissertation's findings emphasise the necessity of sustainable policies that balance security with fiscal prudence, advocating for European cooperation in areas like joint military procurement and infrastructure sharing to manage costs effectively, thereby guiding policymakers toward strategies that support both economic stability and defence commitments.

This dissertation seeks to contribute to the broader debate on defence spending and public budget management by providing an in-depth analysis of how NATO countries are navigating the tension between security needs and fiscal realities. The findings will offer valuable insights for policymakers and defence planners as they work to ensure that NATO remains a strong and capable alliance, even in the face of economic constraints. The research will also highlight the importance of strategic foresight in defence planning, as NATO countries must not only meet their immediate defence obligations but also prepare for future challenges in an increasingly unpredictable global security landscape.

2. Literature Review

2.1 Defence Spending in NATO Countries

Historical Context

NATO’s defence spending has undergone significant changes influenced by various geopolitical and economic factors, particularly during the Cold War era. The alliance’s primary objective during this period was to counter the threat posed by the Soviet Union, which necessitated substantial investment in military capabilities.

NATO was formed in 1949 in response to the expanding influence of the Soviet Union in Eastern Europe. The early years were marked by high defence spending among members, driven by the need to establish a credible deterrent against potential Soviet aggression. The outbreak of the Korean War in 1950 further underscored the necessity for robust military capabilities, leading to increased defence budgets across the alliance. Throughout the 1950s, NATO countries maintained defence spending at high levels, typically averaging more than 3% of GDP. This period saw significant investments in both conventional and nuclear forces to ensure deterrence. The Eisenhower administration’s ‘New Look’ policy in the United States emphasised reliance on nuclear weapons as a cost-effective deterrent, which influenced NATO’s strategic posture and spending patterns. The 1960s presented new challenges, such as the Cuban Missile Crisis in 1962, which brought the world to the brink of nuclear war. This crisis highlighted the importance of maintaining strong defence capabilities and prompted NATO members to sustain high defence expenditures (Trakimavičius, 2019). During the 1970s and 1980s, NATO continued to invest heavily in defence to keep pace with the Soviet Union's military advancements. The introduction of the Intermediate-Range Nuclear Forces in Europe during the late 1970s and early 1980s was a direct response to the Soviet deployment of similar missiles, reflecting ongoing high defence spending. The period was characterized by significant military exercises and the deployment of advanced weapon systems to maintain a strategic balance (Higgs, 1988).

The dissolution of the Soviet Union in 1991 marked a dramatic shift in NATO’s strategic environment. The immediate threat from the East diminished, leading many NATO countries to reduce their defence budgets substantially. The 1990s saw a focus on peacekeeping missions, such as those in the Balkans, where NATO intervened to stabilize the region. This period of reduced spending was part of a broader realignment towards addressing new security challenges and supporting humanitarian efforts (NATO, 2022). The terrorist attacks on September 11, 2001, marked a significant turning point in NATO’s defence strategy and spending. These attacks underscored the emerging threat of global terrorism, leading to increased defence budgets to support military operations in Afghanistan and Iraq. The United States, in particular, significantly increased its defence spending, and other NATO members followed suit to enhance their counter-terrorism capabilities and participate in extensive military campaigns in the Middle East (Foster, 2014).

The annexation of Crimea by Russia in 2014 marked another pivotal moment for NATO, prompting a renewed focus on collective defence. In response, NATO members pledged to increase their defence spending to at least 2% of their GDP by 2024. This commitment has led to substantial increases in defence budgets, with a particular emphasis on modernizing military capabilities and ensuring readiness to respond to renewed geopolitical challenges. By 2024, 23 NATO members are expected to meet or exceed the 2% GDP target, reflecting a unified effort to bolster collective defence and deterrence against potential adversaries (NATO, 2024a). The geopolitical landscape has shifted significantly in recent years, with Russia's aggressive actions posing a major threat to European security. NATO's response has included increased military presence in Eastern Europe and enhanced defence spending. The ongoing conflict in Ukraine has heightened security concerns among NATO members, particularly those in Eastern Europe. This has led to a re-evaluation of defence strategies and an increase in military expenditures (Vergun, 2024). NATO has implemented various measures to address these threats, including the Enhanced Forward Presence in the Baltic States and Poland, and the establishment of rapid response forces (NATO, 2024a).

Overall, NATO's defence spending trajectory reflects its adaptation to the evolving security landscape, from the high budgets of the Cold War to the post-Cold War reductions and the post-9/11 increases, culminating in the significant resurgence of spending in response to recent geopolitical challenges.

The 2% GDP Defence Spending Requirement

The 2% of GDP defence spending requirement is a critical component of NATO's strategy to maintain and enhance its collective defence capabilities. It reflects a commitment to equitable burden sharing and addresses the need for robust defence postures in the face of evolving geopolitical threats. While meeting this target poses economic challenges for some member countries, it is viewed as an essential investment in the long-term security and stability of the alliance. The 2% of GDP defence spending requirement was established by NATO to ensure that all member countries contribute equitably to the alliance's collective defence. This target was formalised at the 2014 NATO summit in Wales in response to heightened security threats, particularly from Russia, following its annexation of Crimea. The guideline aims to reverse the trend of declining defence budgets that many NATO countries had adopted since the end of the Cold War. NATO's 2% guideline is not a binding rule but a political commitment. It serves as a benchmark to encourage members to allocate sufficient resources to their defence budgets, reflecting the shared responsibility for collective security. The target is meant to address both immediate and long-term defence needs, ensuring that NATO remains capable of responding to evolving threats (NATO, 2014a; NATO 2014b). The 2% GDP target ensures that NATO countries invest adequately in their defence capabilities, which is crucial for maintaining the alliance's overall military strength. This investment helps in modernizing equipment, enhancing readiness, and supporting ongoing operations and missions. According to NATO (2024a), achieving the 2% target is essential for funding significant expenditures such as major equipment, research and development, and the maintenance of operational forces.

The target was reinforced due to the perceived threat from Russia. The annexation of Crimea in 2014 and subsequent military actions in Ukraine have underscored the need for robust defence postures among NATO members, particularly those in Eastern Europe. NATO Secretary General Jens Stoltenberg has emphasized the importance of the 2% guideline in maintaining a credible deterrence posture against potential aggressors like Russia. The 2% guideline symbolizes the political commitment of NATO members to collective defence. It addresses long-standing concerns about burden sharing within the alliance, ensuring that all members contribute their fair share to NATO's defence budget. The US Department of Defence has highlighted the significance of equitable burden sharing, noting that increased defence spending by European allies and Canada has strengthened the alliance's overall capabilities (Cordesman, 2019). Meeting the 2% target can be challenging for countries with strained public finances. However, it is seen as a necessary investment in national and regional security. NATO has acknowledged that while some countries may struggle to meet this target immediately, it is crucial for long-term strategic stability. Since the 2014 Wales summit, NATO has made significant progress in increasing defence spending among its members. In 2014, only three countries met the 2% GDP target. However, by 2024, it is projected that 23 allies will reach or exceed this threshold. This increase reflects a growing recognition of the importance of robust defence spending in light of current security challenges. Data from detailed annual reports by NATO show a positive trajectory towards meeting the 2% target and highlight areas where additional efforts are needed (NATO, 2014b; NATO, 2024a).

Recent Declarations and Progress

NATO Secretary General Jens Stoltenberg has consistently emphasised the importance of defence spending among NATO Allies, particularly the goal of allocating 2% of GDP to defence. His declarations over recent months highlight the progress and ongoing challenges in meeting this target. On February 14, 2024, NATO Secretary General reported an 11% increase in defence spending among European Allies and Canada in 2023. He highlighted that 23 Allies were expected to meet the 2% GDP defence spending target in 2024. Stoltenberg emphasised this progress during a press conference in Brussels ahead of a meeting of NATO defence ministers. He remarked that NATO Allies in Europe would collectively invest $380 billion in defence in 2024, equating to 2% of their combined GDP for the first time, a significant increase from 1.47% in 2014. Stoltenberg stressed that 2% should now be seen as a minimum requirement (NATO, 2024b). On March 14, 2024, Stoltenberg, during the release of his Annual Report, underscored NATO's core responsibility in setting defence capability targets and ensuring interoperability among Allies. He reiterated the importance of meeting the 2% GDP defence spending commitment, noting it as a fundamental aspect of NATO's strategic goals. Stoltenberg also highlighted that increased defence investments are crucial for maintaining credible deterrence and addressing new security challenges (Stoltenberg, 2024a). On April 3, 2024, at a joint press conference with US Secretary of State Antony Blinken, Stoltenberg announced that two-thirds of NATO Allies are now spending 2% of their GDP on defence, marking substantial progress since the Wales Summit. This milestone reflects the Alliance's strengthened commitment to collective defence and burden-sharing (Stoltenberg, 2024b). On June 13, 2024, ahead of the NATO Ministers of Defence meeting, Stoltenberg once again discussed the need for Allies to meet their defence spending commitments. He indicated that the upcoming updated figures would demonstrate positive progress towards the 2% GDP target. This meeting set the stage for further discussions on the necessity of sustained defence investments and effective burden-sharing among NATO members (Stoltenberg, 2024c). On June 17, 2024, Stoltenberg made several critical declarations. He announced during a meeting with US President Biden that defence spending across Europe and Canada had risen by 18% in 2024. Since 2014, NATO Allies have collectively added over $640 billion in defence spending. He reiterated that more than 20 NATO members would meet the 2% GDP target in 2024, underscoring the Alliance's growing strength and solidarity (Stoltenberg, 2024d). In a speech at the Wilson Center, Stoltenberg highlighted that since the 2014 pledge, European Allies and Canada had increased their defence spending by over $600 billion. He emphasised that this level of investment is now considered a minimum requirement, reinforcing NATO's unity and strength in supporting Ukraine and countering Russian threats (Stoltenberg, 2024e). These declarations by NATO Secretary General underline the significant progress NATO Allies have made in meeting the 2% GDP defence spending target. This commitment to increased defence budgets reflects a strengthened alliance, better prepared to address current and future security challenges. The consistent emphasis on meeting the 2% target as a minimum requirement highlights the evolving security landscape and the need for sustained investments in defence capabilities to ensure NATO's readiness and interoperability.

Similar declarations have been made by other NATO countries' prime ministers on the European side of the alliance, underscoring the critical importance of meeting the 2% of GDP defence spending target to reinforce the Alliance's collective security and deterrence capabilities. This commitment reflects a unified stance against emerging security threats, particularly from Russia, and underscores the necessity of robust defence investments to maintain NATO's operational readiness and strategic influence. Belgian Prime Minister Alexander De Croo and Defence Minister Ludivine Dedonder have outlined Belgium's plans to increase its defence spending, despite being currently one of the lowest spenders in NATO. De Croo has pledged to reach the 2% GDP target by 2033, while Dedonder specified an increase to 1.24% in 2024. This incremental approach aims to enhance Belgium's defence capabilities and contribute more effectively to NATO's collective security framework (Realfonzo, 2024). In Estonia, Defence Minister Hanno Pevkur has called for even higher defence spending targets, proposing a 2.5% GDP goal for the Alliance due to the significant threat posed by Russia. Estonia, already spending over 3% of its GDP on defence, exemplifies a proactive stance in ensuring national and regional security within NATO (DNYUZ, 2024). Similarly, Polish Prime Minister Donald Tusk emphasised Poland's robust defence expenditures, which exceed 3% of GDP. Tusk stressed that maintaining high defence spending is crucial for national security and supports NATO's strategic objectives, especially in the context of the ongoing conflict in Ukraine (Reuters, 2024). German Defence Minister Boris Pistorius highlighted Germany's steps towards meeting the 2% GDP target, including the construction of a new ammunition factory. This initiative is part of Germany's broader effort to enhance NATO's defence capabilities and ensure long-term military readiness (Brussels Times, 2024). Meanwhile, Canadian Defence Minister Anita Anand reaffirmed Canada's commitment to the 2% GDP defence spending target, emphasising the necessity of this investment for NATO's collective defence and operational effectiveness (NATO, 2024c). French President Emmanuel Macron reiterated France's dedication to increasing defence spending to meet NATO's target, underscoring the importance of these investments in maintaining European security and strengthening NATO's deterrence capabilities (NATO, 2024c). In the United Kingdom, Defence Secretary Ben Wallace confirmed that the UK would maintain its defence spending at 2% of GDP or higher, highlighting the role of consistent investment in supporting NATO operations and sustaining the UK's defence capabilities (NATO, 2024c). Finally, Finnish Prime Minister Sanna Marin emphasised Finland's commitment to defence spending, aiming to meet and exceed the 2% GDP target as a new NATO member. This commitment reflects Finland's strategic priority to bolster its defence capabilities amidst regional security challenges (Realfonzo, 2024).

These declarations collectively highlight the growing commitment among NATO member states to meet the 2% GDP defence spending target. This commitment is essential not only for national security but also for maintaining the collective strength and deterrence capabilities of the Alliance. As geopolitical challenges persist sustained and equitable defence investments will remain a cornerstone of NATO's strategy to preserve peace and security in the Euro-Atlantic area.

2.2 Public Budget Constraints and Defence Spending

Public Budget Constraints Definition and Scope

Public budget constraints, or fiscal constraints, are essential considerations in the management of national budgets, particularly concerning defence spending. These constraints entail the limitations imposed on government expenditures by available financial resources, necessitating careful prioritization and allocation to maintain fiscal health and sustainability.

Public budget constraints refer to the financial limits within which a government must operate when planning and executing its budget. These constraints are influenced by various factors, including revenue generation, existing debt levels, economic conditions, and fiscal policies. At its core, a government's ability to finance its operations and investments, such as in defence, without incurring unsustainable debt levels, is critical to maintaining fiscal discipline. The concept is encapsulated in the intertemporal budget constraint, which posits that the present value of future primary surpluses must cover the current stock of public debt (OECD, 2021). This principle means that any increase in government spending, such as on defence, must be balanced by either increased revenues (e.g., higher taxes) or reduced spending in other areas. Alternatively, the government may resort to borrowing, which must be managed within sustainable limits to avoid excessive debt accumulation (SpringerLink, 2021). Fiscal rules are formal constraints on budgetary aggregates such as expenditures, deficits, and debt levels. These rules are designed to prevent fiscal irresponsibility by setting clear limits on budgetary practices. For example, expenditure rules might limit the growth rate of public spending, while budget balance rules could mandate that budgets be balanced over a specific period, thus preventing chronic deficits (OECD, 2021). The effectiveness of fiscal rules in maintaining budget constraints is influenced by their design and implementation. Successful fiscal frameworks often integrate multiple elements, such as independent fiscal institutions that provide oversight and transparency, and medium-term expenditure frameworks that align short-term budgets with long-term fiscal goals. Countries with robust fiscal rules and institutions tend to exhibit better fiscal discipline, reducing the likelihood of excessive deficits and debt accumulation (OECD, 2021; SpringerLink, 2021).

Despite the advantages of fiscal rules, governments often face significant challenges in adhering to budget constraints. Political incentives and social constraints can lead to fiscal slippages, particularly in periods leading up to elections when there is pressure to increase spending or reduce taxes to gain electoral favour. This behaviour, known as the deficit bias, results in a systematic tendency to run budget deficits, complicating efforts to maintain fiscal discipline (Montiel, 2003). Moreover, economic shocks and structural changes, such as aging populations, climate change, and health crises, exert additional pressure on public finances. These factors necessitate increased spending in areas like pensions, healthcare, and environmental protection, further constraining the fiscal space available for other priorities like defence. There is the need for resilient fiscal policies that can adapt to such challenges while maintaining fiscal sustainability. This involves not only adhering to fiscal rules but also enhancing budgetary processes and transparency to build public trust and support for necessary fiscal measures (OECD, 2021).

Theoretical Framework

The relationship between public budget constraints and military expenditures within military alliances, particularly NATO, has been a focal point of extensive scholarly research.

Alliance theory provides a foundational framework for understanding the distribution of defence burdens among member nations. Traditional alliance theories often emphasize the uneven distribution of defence spending, where larger and wealthier allies bear a greater share of the costs. This phenomenon is grounded in the classification of defence outputs as either private or public goods. Private goods in defence are rival and excludable, benefiting only the nation that provides them. In contrast, public goods, such as the collective security provided by NATO's nuclear deterrent during the Mutual Assured Destruction era, are non-rival and non-excludable, offering benefits to all alliance members without additional costs per new member (NATO, 2016). The analysis of military alliances as a public good, pioneered by Olson and Zeckhauser (1966), remains foundational. They proposed that collective security benefits all members without excluding any, which leads to potential free-riding where some members might benefit from security without making proportionate contributions. This theoretical approach was further extended by scholars like Murdoch and Sandler (1982, 1984), who noted that such alliances often result in suboptimal allocation of defence expenditures due to this free-riding problem. Recent advancements in alliance theory suggest a strategic shift in response to future budgetary constraints. This shift involves increasing the private benefits of alliance membership through activities such as intelligence sharing, specialization in niche capabilities, and cooperative defence initiatives. By aligning national investments with NATO priorities, members can balance the defence burden more equitably and stabilize their defence budgets. Empirical evidence from NATO's Flexible Response era supports this approach, showing that as nations invested more in conventional deterrence, the benefits of defence spending became more country-specific, aligning burdens and benefits more closely (NATO, 2016). Sandler and Hartley (2001) introduced the joint-products model, which differentiates between public and private benefits of defence spending. They argued that when military expenditures yield significant private advantages to individual countries, the issues predicted by the pure public goods model, such as free-riding, are mitigated. This model suggests a more balanced burden-sharing within alliances compared to the pure public goods model. However, the measurement of burden asymmetry remains complex due to the imprecise definitions of public and private benefits.

The supply side of military goods is heavily influenced by government policies, with governments typically acting as monopsonies, or sole purchasers, thereby shaping the size and structure of the defence industry. The supply side literature on defence spending focuses on the unique market structures of military procurement, characterized by monopolistic or oligopolistic conditions due to the high complexity and specialization of military goods. Sandler and Hartley (1995) emphasized that government regulation plays a critical role in determining the viability and profitability of the defence industry. They noted that defence industries are characterized by high fixed costs and intensive research and development requirements, necessary to maintain technological superiority. Governments often act as the sole buyers in these markets, facing a limited number of large defence contractors. This market structure leads to inefficiencies and higher costs, further exacerbated by the uncertainties associated with future threats and technological advancements. Rogerson (1995) detailed the market failures in defence procurement, including issues like private information, imperfect monitoring, and the difficulty of enforcing long-term contracts. He also highlighted the presence of significant economies of scale in the production of military goods, which often leads to a limited number of suppliers and exacerbates market power imbalances. Transaction cost economics offers solutions to these issues by advocating for multi-year contracts and public-private partnerships to stabilize demand and incentivize performance (NATO, 2016). The production of military capabilities is another focal point within the supply side literature. This approach emphasizes the combination of inputs such as personnel, weapon systems, and infrastructure to generate effective military outcomes. The NATO's (2016) study highlights the importance of rationalizing defence capabilities and programs to increase force effectiveness, especially in the face of fiscal constraints. Strategic planning and the harmonization of national and NATO defence plans are essential to ensure deployable and sustainable capabilities. This environment necessitates specific government interventions to ensure the efficient procurement and deployment of military resources.

The demand side of military expenditures is influenced by various factors, including external threats, internal economic pressures, and alliance theory determinants. Central governments must balance competing demands between civilian and military goods, influenced by relative prices and voter preferences. Factors such as national sovereignty threats and obligations within collective security arrangements play a significant role in shaping defence budgets. Studies suggest that lowering the relative costs of military goods through specialization, pooling resources, and collaborative efforts can enhance efficiency and maintain defence capabilities despite budget constraints (NATO, 2016). Hartley and Solomon (2009) suggested that budgetary constraints might drive NATO members to focus more on defence outputs rather than inputs, encouraging alternative combinations of military resources and greater collaboration among alliance members. They proposed that these pressures could enhance efficiency by exploiting synergies and comparative advantages, though significant challenges in integration and coordination remain. The financial crisis of 2008-2009 significantly impacted defence spending across NATO member nations, prompting a re-evaluation of budget allocation strategies. The demand side research underscores the necessity for innovative approaches to defence funding, including prioritizing essential capabilities, enhancing transparency in resource management, and leveraging economies of scale through cooperation among alliance members (NATO, 2016). The examinations of austerity measures' impact on defence budgets by Larrabee et al. (2012) and Sandler and Shimizu (2014) underscore the potential for both negative and positive outcomes. While budget cuts may weaken NATO's overall military capacity, they also present an opportunity to reform inefficient practices and encourage greater collaboration and specialization among member states. The success of these initiatives, however, depends on overcoming substantial political and operational barriers.

The theoretical framework for analysing the demand for military expenditure often employs a neoclassical model, as presented by Smith (1980), which includes a social welfare function dependent on security and civilian production. In this model, security is influenced by military expenditure and the international security environment. The government's objective is to maximize welfare, constrained by economic output. Empirical applications typically focus on the military expenditures of potential adversaries and allies, which influence threat perceptions and defence spending behaviours. Historical analyses have shown that countries like the UK and France have exhibited follower behaviour in their defence spending relative to the US and the Soviet Union during the Cold War (Smith, 1989; Dunne, Pashardes, and Smith, 1984; Nikolaidou, 2008). Empirical studies on the demand for military expenditure usually incorporate GDP or GDP growth as explanatory variables, often neglecting specific fiscal indicators. For instance, Smith's (1995) review and subsequent studies (Nikolaidou, 2008; Dunne, Perlo-Freeman, and Smith, 2008; Douch and Solomon, 2014; Abdelfattah et al., 2014) have primarily relied on GDP measures. Although some attempts have been made to consider the opportunity costs of defence spending by including non-defence public spending (Sezgin and Yildirim, 2002), this approach does not fully capture the fiscal policy stance or the role of deficits and public debt as potential constraints or enablers of defence expenditure. A few studies have explicitly included fiscal variables in their analyses. Harris (1986) found a strong positive relationship between defence expenditure and the central government budgetary position in ASEAN countries. In France, Coulomb and Fontanel (2005) and Lelièvre (1996) documented that defence spending was one of the first areas to be cut during budgetary restrictions. Additionally, Özsoy (2008) found that in Turkey, budget deficit shocks did not significantly impact defence spending, whereas shocks to defence spending negatively affected the deficit. Similarly, Arvanitidis, Kollias, and Messis (2017) found that public debt and fiscal deficit variables were not significant in explaining β-convergence of defence spending efforts among NATO allies. The policy literature from the 2009-2014 period highlighted the concept of "defence austerity," where broader fiscal consolidation efforts led to defence spending cuts. Analyses during this period emphasized cost-saving measures and efficiency improvements, assuming that defence budget increases were not feasible (Antill, Ito, and Robinson, 2013; Valasek et al., 2012). Concerns were raised about the impact of such austerity on European defence capabilities (Major and Moelling, 2013; Urban, 2015). These discussions consistently attributed defence austerity to broader fiscal austerity aimed at managing heightened public debt and deficits (European Parliament, 2011; The Economist, 2013). This suggests a strong case for revisiting the demand for military expenditure with a focus on fiscal conditions, especially in the EU context, where legal and institutional factors make fiscal indicators particularly relevant. Recent empirical work has sought to bridge the gap in the literature by focusing on the role of fiscal constraints in determining military expenditure, particularly within the European context. Christie (2017) develops an empirical model incorporating a new indicator termed "fiscal capacity," which measures the fiscal margin available to governments for increasing public expenditure while maintaining sustainable debt levels. The study finds that fiscal capacity outperforms traditional economic indicators like GDP growth forecasts in explaining variations in defence spending as a share of GDP among European nations during the 2007-2016 period. This suggests that fiscal constraints are a significant determinant of military expenditure decisions. Christie's analysis also emphasizes the impact of the security environment on defence spending. The resurgence of Russia as a military threat has prompted increased defence expenditures in Europe, with the magnitude of the response varying by geographical proximity to Russia. Countries with closer proximity or direct land borders with Russia have shown more substantial increases in defence spending. Moreover, the study reveals a pattern of follower behaviour among European nations relative to US defence spending changes, indicating that reductions in US military expenditure from 2009 to 2015 may have encouraged similar cuts in Europe. These findings highlight the importance of considering both fiscal capacity and security threats in understanding defence spending dynamics in contemporary Europe.

Public opinion is another factor that plays a pivotal role in constraining demand for defence spending, particularly in democratic societies. Research has consistently shown that the electorate tends to prioritize welfare ('butter') over military ('guns') expenditures, particularly in times of economic austerity. Studies such as those by Eichenberg and Stoll (2003) and Nordhaus, Oneal, and Russett (2012) have demonstrated a correlation between external threats and aggregate military spending, suggesting that threat perceptions can mitigate the public's aversion to defence expenditure. However, the operationalization of these threats and the causal mechanisms linking them to public support for military spending remain complex and underexplored (Becker, 2019; Haesebrouck, 2019).

Defence Spending and Economic Downturns

Understanding the impact of economic downturns on defence spending is crucial for assessing national security and fiscal policies. During periods of economic strain, governments often face difficult choices regarding budget allocations, and defence spending can be significantly affected. Examining these effects provides insights into how countries prioritize security amidst financial challenges. Numerous studies have explored the impact of the Great Recession on defence spending in several NATO countries, highlighting how economic pressures influenced military budgets and strategic decisions during this critical period.

The global financial crisis of 2008 and subsequent austerity measures intensified the focus on efficient defence spending within NATO. Keller (2010) discussed how economic downturns prompt NATO members to explore efficiency-enhancing measures such as pooling, sharing, and specialization of military resources. He highlighted the critical challenge of ensuring credible commitments to shared sovereignty and trust among member states, which are essential for the effectiveness of these measures. Larrabee et al. (2012) provided an empirical examination of the effects of austerity on defence spending, noting significant planned cuts driven primarily by budgetary pressures rather than changes in the security environment. They argued that such cuts, while necessary, could leave NATO ill-equipped to meet its primary security obligations, particularly as the US shifts its strategic focus to Asia. The authors proposed several policy options to address these challenges, including enhanced bilateral and plurilateral cooperation agreements, pre-emptive crisis management, and the use of informal ad hoc coalitions to maintain operational capabilities.

Empirical research on defence spending within NATO highlights the varied responses of member nations to economic pressures. For instance, the UK and Canada implemented significant budget cuts, deferring modernization projects and reducing overall defence expenditures. These measures, while necessary for fiscal stability, posed challenges to maintaining military readiness and capability development. Conversely, some nations increased their defence spending in response to specific threats, illustrating the complex interplay between economic constraints and security imperatives (NATO, 2016).

During the Great Recession, countries like Canada, the USA, and the UK implemented aggressive economic stimulus measures to counteract economic downturns. These measures included tax cuts, increased public benefit spending, and substantial investments in infrastructure and education. While these actions helped stabilize national economies, they also led to increased national debts and necessitated budget cuts in other areas, including defence. In response to rising national debts, several countries introduced stringent budget control measures. The USA's Budget Control Act of 2011 is a notable example, imposing caps on discretionary spending and leading to significant reductions in defence budgets. These legislative measures aimed to reduce fiscal deficits but also required careful balancing to avoid compromising national security (NATO, 2016). Many NATO member nations targeted defence spending for reductions as part of broader fiscal consolidation efforts. Slovakia, for example, reduced its defence budget by 0.5 percentage points of GDP, postponing investment and modernization projects. Similarly, Canada deferred several key capital projects, reducing its defence budget by an average of 4% per year over five years. These reductions highlight the trade-offs countries face between fiscal responsibility and maintaining defence capabilities. The NATO (2024a) study identified a range of resource management strategies employed by NATO member nations to mitigate the impact of budget constraints. These strategies include improving transparency and accountability in the resource management process, generating operating efficiencies, and promoting assessment mechanisms. By adopting these strategies, NATO members can better navigate financial constraints while maintaining effective defence capabilities (NATO, 2016).

Impact of Defence Spending on Macroeconomic Conditions

The literature on defence economics has extensively examined the impact of defence expenditure on macroeconomic conditions, such as economic growth and public debt. Notable studies include those by d'Agostino, Dunne, and Pieroni (2017), and Dunne and Tian (2016), which provide recent estimates on large panel data sets. Other research has focused on the implications of defence spending on external debt, especially in developing countries, and a smaller subset of studies have explored the impacts on public debt in European nations (Alexander, 2013; Paleologou, 2013; Caruso and Di Domizio, 2016).

Since Benoit's pioneering work in the 1970s, numerous studies have investigated the impact of military expenditure on economic growth. Benoit (1973, 1978) found a positive relationship between defence spending and economic development in developing countries, suggesting that military expenditure can stimulate economic growth through various channels such as increased aggregate demand and technological advancements. Subsequent research has both supported and challenged Benoit's findings. For instance, Smith (1980) and Faini et al. (1984) explored the Keynesian perspective, highlighting the multiplier effects of defence spending on aggregate demand and employment. Conversely, studies from a neoclassical viewpoint, such as those by Chan (1986) and Yakovlev (2007), argue that high military expenditure may crowd out investment in other productive sectors, thereby inhibiting long-term economic growth. These conflicting perspectives underscore the complexity of the defence-growth nexus, suggesting that the impact of military spending on economic performance is context-dependent and influenced by a variety of factors including the structure of the economy, the efficiency of public spending, and the geopolitical environment. The study by Gómez-Trueba Santamaría et al. (2021) adds significant empirical evidence to the ongoing debate. By examining data from 28 NATO countries over the period 2005-2018, the authors identified distinct models for different groups of countries within the Alliance, suggesting that the impact of defence expenditure on GDP varies significantly depending on historical and economic contexts. Their findings indicate that while there is a general positive impact of military spending on GDP, the magnitude and persistence of this effect differ across countries. For instance, nuclear-armed NATO members experience a more pronounced positive impact compared to non-nuclear members. The study's methodological rigor, including the use of the Arellano-Bond dynamic panel model and the poolability test, ensures robust results. These results underscore the necessity of considering country-specific factors when formulating defence spending policies and evaluating their economic implications. Moreover, the study highlights the importance of defence investment not only for national security but also for broader economic stability and growth within the Alliance. The literature on the relationship between defence spending and economic growth reveals a complex and nuanced interplay. While some studies affirm the positive economic impacts of military expenditure, others caution against the potential for resource misallocation. The empirical evidence from NATO countries, particularly the recent findings by Gómez-Trueba Santamaría et al. (2021), emphasizes the importance of context-specific analyses. These insights are crucial for policymakers aiming to balance national security needs with sustainable economic development.

Overall, this literature review highlights how intricate the relationship between public budget constraints and defence spending in NATO countries is. It delves into the historical context, recent threats, and the economic dynamics that shape defence expenditure. Historically, NATO's defence spending patterns have been shaped by significant geopolitical shifts, from the substantial military investments during the Cold War to the strategic realignments post-Cold War. The resurgence of Russian aggression, particularly following the annexation of Crimea in 2014 and the invasion of Ukraine, has prompted NATO members to reassess and bolster their defence budgets. The commitment to the 2% GDP defence spending target, reaffirmed in recent years, reflects a collective acknowledgment of the need for robust defence postures. This review highlights the multifaceted economic factors influencing defence spending. The interplay between GDP growth, fiscal policies, and economic crises necessitates a delicate balance between military expenditure and other public spending priorities. Empirical studies illustrate that defence budgets are often the first to be adjusted in times of economic austerity, underscoring the vulnerability of military spending to broader fiscal constraints. Alliance theory provides a foundational framework for understanding burden-sharing within

NATO, revealing the complexities of equitable defence contributions amidst public goods dynamics. The tendency for free-riding, where some member states benefit from collective security without proportional contributions, remains a critical challenge. Advancements in alliance theory suggest strategic shifts towards increasing private benefits of alliance membership through intelligence sharing, specialization, and cooperative defence initiatives. The supply and demand sides of military expenditures present unique challenges and opportunities. The supply side is characterized by high fixed costs and specialized procurement processes, often resulting in monopolistic market structures and inefficiencies. On the demand side, factors such as external threats and internal economic pressures significantly influence defence budgets. Innovative approaches, including resource pooling, specialization, and enhanced cooperation, are vital for maintaining defence capabilities amidst fiscal constraints. Empirical evidence underscores the impact of economic downturns on defence spending, with varied responses across NATO member nations. The Great Recession exemplified how fiscal pressures led to significant defence budget cuts, deferrals of modernization projects, and the pursuit of efficiency-enhancing measures. Despite these challenges, the resurgence of defence spending in response to renewed threats illustrates the dynamic nature of defence budget allocations. Moreover, the review emphasizes the importance of integrating fiscal capacity and security threats in defence spending analyses. Recent studies highlight the role of fiscal space, defined as the fiscal margin available for public expenditure increases while maintaining sustainable debt levels, as a crucial determinant of defence spending variations. The influence of public opinion, particularly in democratic societies, further constrains defence expenditure, with electorates often prioritizing welfare over military spending.

In conclusion, navigating the complexities of defence spending within the context of public budget constraints requires a nuanced understanding of geopolitical dynamics, economic factors, and alliance theories. Policymakers must adopt innovative strategies to balance national security imperatives with fiscal sustainability. Continued research is essential to support informed decision-making, ensuring that NATO remains capable of addressing evolving security challenges while managing economic constraints effectively.

3. Research Question and Methodology

3.1 Research Question

This thesis focuses on the challenge of reconciling the need for increased defence spending with the fiscal constraints faced by NATO member states. NATO countries, particularly in Europe, are under mounting pressure to meet the alliance's defence spending target of 2% of GDP. This obligation comes at a time when member states are grappling with competing demands for public spending in sectors such as healthcare, education, and social services. These challenges are further exacerbated by economic strains caused by global uncertainties, including inflation and rising interest rates, which complicate defence budgeting. Therefore, it is essential to explore how NATO member states are navigating these fiscal constraints while ensuring adequate defence funding and what implications this balance has for collective security within the alliance.

This tension raises a fundamental question: How are NATO member states reconciling the need for increased defence spending—given the challenges posed by a changing geopolitical environment—with existing fiscal constraints in their national budgets, and what are the implications for collective security?

This research explores how NATO countries are adapting to balance the necessity for increased defence spending with the fiscal realities of their national budgets. Rising geopolitical tensions, particularly due to Russian aggression and the evolution of hybrid warfare, underscore the urgent need for NATO nations to enhance military capabilities. However, many of these countries face significant economic challenges, including inflation, rising interest rates, and competing demands for public spending on essential services like healthcare and education. The analysis considers the interplay between defence spending and macroeconomic factors, examining how these influences affect member states' budgeting priorities. Additionally, the analysis highlights the concept of strategic autonomy within the EU and discusses the implications of public sentiment towards defence expenditures. By examining the intersection of defence policy and public finance, this research aims to contribute to the broader discourse on national security within NATO. It seeks to identify practical solutions for member states to boost defence spending while effectively managing fiscal pressures, ultimately strengthening the alliance's collective operational readiness in a complex global landscape.

3.2 Research Methodology

This dissertation follows a qualitative research methodology, using a combination of academic literature, reports from international organisations, and the analysis of official statistical data. Given the complexity of the subject matter, a qualitative approach allows for an in-depth exploration of the intricate factors influencing defence spending decisions in NATO countries. The research question is addressed through multiple lenses—economic, political, and security—enabling a holistic understanding of the fiscal dynamics at play.

The backbone of the research is a thorough review of the relevant academic literature. The literature surveyed covers areas of economic policy, defence economics, public finance, and international relations. By synthesising these diverse fields, the research explores how different theoretical frameworks interpret the relationship between fiscal constraints and defence spending. Key academic works on NATO's defence strategy, public budget allocation, and security economics have been analysed to provide a strong foundation for the research. The literature review focuses on identifying the principal arguments that explain how defence spending has evolved under economic pressure and the implications this has had for both national and collective security.

The research also draws heavily from documents produced by international organisations, primarily NATO, the European Union, and the Organisation for Economic Co-operation and Development (OECD). These sources offer invaluable insights into the defence spending commitments of NATO members and provide a broader policy context for national budgeting decisions. Reports, policy briefs, and official statements are used to evaluate how NATO's directives on defence spending, particularly the 2% GDP target, have been implemented by member states. Additionally, these documents provide critical data on how countries are performing against their commitments and the external factors—such as rising geopolitical tensions—that are affecting defence budgets. A key component of the methodology is the use of statistical data to analyse trends in defence spending among NATO countries. The data used in this research is up-to-date as of July 2024, ensuring that the analysis reflects the most current fiscal and defence policies in place. The statistical data is sourced from official reports published by NATO, national governments, and international financial institutions such as the International Monetary Fund and the World Bank. This data provides concrete evidence of how much NATO members are allocating to defence spending, the proportion of national budgets devoted to defence, and how these allocations have changed in response to both internal and external pressures. The statistical analysis offers a robust, quantitative foundation for assessing the fiscal health of NATO countries and their capacity to meet collective security obligations. By identifying commonalities and divergences in defence spending practices, the research aims to uncover broader trends and make informed predictions about the future of defence financing in NATO countries. The research ensures that all data used is accurately sourced and appropriately referenced.

This research is particularly relevant in the context of contemporary global security dynamics. The post-Cold War era has seen a resurgence of geopolitical tensions, with NATO facing new challenges from both state and non-state actors. The importance of understanding how member states prioritise defence spending amid budget constraints cannot be overstated, especially as collective security relies on the commitment of individual countries to uphold their obligations. The findings of this dissertation aim to inform policymakers and stakeholders within NATO and its member states about the fiscal realities that underpin defence budgets. By elucidating the complexities surrounding public budget constraints and defence spending, this research contributes to the ongoing discourse about national and collective security in an increasingly interconnected world. It addresses critical questions about the sustainability of NATO's defence posture and highlights the necessity for adaptive strategies that allow member states to fulfil their obligations without compromising essential domestic programs. Ultimately, the dissertation endeavours to provide a comprehensive framework for understanding the intricate balance between fiscal responsibility and national security, offering insights that are pertinent not only to NATO but to global security arrangements at large.

4. Analysis

4.1 Overview of the Geopolitical Environment

In 2024, the peace and security landscape in and around Europe remains highly volatile. Russian military operations in Ukraine have intensified, marked by significant advances in the Donbas and Kharkiv regions. These activities represent deeply unsettling developments that undermine the apparent stabilization observed since March 2023. At the same time, the fragile peace in the Western Balkans is under stress. The Serb majority in Bosnia is getting closer to secession within the entity of Republika Srpska, and long-standing disagreements between Kosovo and Serbia continue to fan regional friction. Another source of important concern is the Middle East. The Israeli campaign of repression in Gaza, a response to Hamas attacks in October 2023, has unleashed a humanitarian catastrophe that has killed upward of 35,000 Palestinians and left a devastating famine looming over the area (Crisis Group, 2024b). The International Criminal Court prosecutor is getting ready to issue arrest warrants against leaders from both sides, accusing them of war crimes and crimes against humanity. The civil war in Sudan, now in its second year, has already had a catastrophic human cost and looms over the stability of that country for generations.

Under the current leadership of Ursula Von der Leyen, the EU is expected to have a stronger geopolitical role. Since 2019, when Von der Leyen assumed the presidency of the European Commission, the EU has been able to move ahead along the path of defence capability development and claim its rightful place, especially in regard to Russia's aggression against Ukraine. The EU's unity in delivering substantial military and non-military aid to Ukraine, along with enforcing severe sanctions against Russia, has enabled a strong collective response. However, significant obstacles remain in realizing the goal of strategic autonomy—championed by French President Emmanuel Macron—for a more sovereign Europe capable of defending its political, security, and economic interests. First among these challenges is the EU's reliance on US military support, which exposes its vulnerability, with military aid to Ukraine exemplifying this dependence. Additionally, this trajectory could become even more precarious if the US presidential election brings Donald Trump back to office, given his stance on reducing American support for European defence. In addition, as many as one-third of the bloc's 27 members seem unable to reach a consensus regarding a common approach towards China. While there are numerous initiatives to decrease economic dependence on Beijing, they are offset by the different views voiced by EU leaders and member states. Relations with the Global South have also reached a boiling point, driven by historical resentments and perceived inequities in the management of global challenges like the COVID-19 pandemic and climate change, as well as the fallout of Ukraine-related sanctions on fragile economies. These relationships are further complicated by the perception of Western double standards on a wide array of issues, like the difference in responses to the conflicts in Ukraine and Gaza.

It is a necessity for the EU to invest more in hard power to address the challenges posed by an aggressive Russia and a potentially unreliable US. However, the importance of continued investment in tools to prevent war and humanitarian crises remains, both within Europe's borders and globally. The following is a detailed overview of the geopolitical environment relevant to EU and NATO interests, divided by region. The analysis draws from the updates provided by the UN through the Office for the Coordination of Humanitarian Affairs (OCHA)[1] and the UN News platform[2] and from the reports published by The International Crisis Group during the first half of 2024 through the Crisis Watch program, with the last update being June 2024[3].

North Africa

The country of Algeria saw heightened political activity during June and July 2024 as it prepared for a presidential election in September. President Abdelmadjid Tebboune has convened the electoral body but has, as yet, refrained from announcing his candidacy. Youcef Aouchiche of the Front des Forces Socialistes and Saïda Neghza, the president of the Confédération Générale des Entreprises Algériennes, are among the main aspirants. Social unrest erupted over the continuing water shortages, culminating in rioting in Tiaret. In a bid to avert further unrest, the government took measures to provide drinking water. On the economic front, Algeria's state oil and gas company, Sonatrach, signed deals with Chinese Sinopec and the US company Chevron to increase the production of the southern gas fields. At the international level, the European Commission launched a dispute settlement procedure against Algeria on charges of hindering European exports and investments in violation of the 2005 trade accord (Crisis Group, 2024c).

Egypt is already facing an acute economic crisis, and the Gaza war has dealt it another blow. Even prior to the outbreak of war, the Egyptian economy was very fragile, given that it is highly dependent on food and fuel imports and short-term financing, all of which it can barely afford. Egypt has an unsustainable debt burden and a worsening cost-of-living crisis that began in 2022. Most of the European leaders are concerned that unrest in Egypt will have far-reaching consequences for the stability of the region and the Suez Canal, which remains vital for trade. The war in Gaza presents additional challenges to Egypt, notably the fear of spillovers that may force Palestinians into the Sinai. Egypt has flatly rejected the idea of "voluntary emigration" of Palestinians from Gaza, as some leaders in Israel have pitched. It's concerning that this massive potential influx of Palestinian refugees could lead to protests and mass mobilization. The worsening humanitarian situation in Gaza, with increased displacement and deterioration, raises the stakes in these concerns for Cairo. The economic fallout from the Gaza conflict in Egypt has been dire. Interruptions of natural gas supplies from Israel have caused lengthy power outages and reduced gas exports. Meaningful cancellations by tourist visitors, particularly in the Sinai, have been recorded, with attacks by Houthi insurgents on Suez Canal traffic reducing revenues. These, coupled with spillovers from Russia's war in Ukraine and interest rate hikes worldwide, have all added to enlarge the current account deficit, diminish foreign reserves, and boost external debt—drawing closer to a risk of default. The national currency, the Egyptian pound, has been devalued quite a lot, and inflation broke all records.

[1] https://reports.unocha.org/
[2] https://news.un.org/en/
[3] https://www.crisisgroup.org/crisiswatch/crisiswatch-pdf-archive

However, the Egyptian authorities, fearing further destabilisation, have been quite reluctant to enforce the reforms that are necessary. In 2023, the IMF withheld a $3 billion loan instalment over Egypt's reluctance to deliver on agreed reforms, from clipping the military's dominance of the economy to floating the pound (Crisis Group, 2024a). The Gaza war has increased already rising economic pressures, with the black-market rate for the pound going up. Moreover, Gulf and Western partners have also expressed interest in providing support to Egypt. The United States hinted at the possibility of offering financial support, whereas the European Union is putting together a similar support package as that advanced to Tunisia—involving unconditional aid mixed with some macro-financial assistance conditioned on an IMF deal. The IMF is also revising its loan conditions for Egypt and may lighten them up to make things easier to digest domestically. This no doubt will bring some short-term relief to the economy but does not correct, in the longer term, major structural imbalances. Among these are major economic runs under the control of the military. The destabilisation of Egypt can have far-reaching consequences, ranging from global trade routes and migration patterns to regional politics. The Rafah border crossing between Egypt and Gaza remains closed despite diplomatic efforts to negotiate its reopening for humanitarian aid following Israel's offensive in Rafah and the taking of control over the borderline. Egyptian, Israeli, and US officials have been trying to find a compromise with no success—the Egyptians were firm about complete Israeli withdrawal from the border and administration of the crossing by neutrals. Recently, the government of Egypt has announced drastic economic measures that raised the price of subsidised bread, about 60 percent more than it has been in three decades, in order to trim subsidy spending and reduce long-term debt. Such measures did not spark protests, despite the dire economic conditions. President Sisi has reappointed Prime Minister Madbouly with a mandate to form a new government to pursue politically sensitive economic reforms needed to regain the confidence of international creditors. Finally, an agreement was made between the EU and Egypt that provided €1 billion for financial aid to back these economic reforms and strengthen the private sector (Crisis Group, 2024c).

Libya remains stuck in a political stalemate between its two rival governments. The UN envoy has emphasised the need for an inclusive process to overcome the standoff. On the more optimistic side, though, the High National Elections Commission did extend voter registration for municipal elections as high demand swamped the process. Poor financial management persisted, as a dialogue on the 2024 budget in Tunis—hosted by the United States—ended without facilitating an agreement. The US imposed sanctions on a Russian company producing the country's currency over alleged counterfeiting of Libyan money. Russia's military presence in Libya increased as its warships stopped in Tobruk, and Moscow made an announcement to enhance closer military ties. Libya delayed the reopening of the Ras al-Jidir border crossing with Tunisia, citing militia presence, despite an agreement that it would open for humanitarian and diplomatic passage (Crisis Group, 2024c; OCHA, 2024a).

Tunisia remained at the forefront of both social unrest and political tension as the country gears up for a presidential election, expected by October. Protests over water shortages and police tactics underlined social discontent. On the political front, an election date stayed off the cards, while internationally, relations with the EU seemed strained as Tunisia drew closer to China and Iran. The presence of President Kais Saied at the Sino-Arab Cooperation Forum delivered a strategic partnership with China, while Tunisia abolished visa requirements for Iranian and Iraqi tourists. Despite strong ties with Italy, Tunisia's relations with other European nations were strained amid Tunisia's rapprochement with Russia, Iran, and China. The UN, following an appeal by the Italian government, recognised the search and rescue zone in the Mediterranean Sea belonging to Tunisia in a bid to regulate the influx of migrants into Europe (Crisis Group, 2024c).

Sahel

At the heart of the Sahel region, Burkina Faso, Mali, and Niger have undergone major political changes since 2021, with coups having been carried out in all three countries. The new regimes distanced themselves from France, their foremost foreign ally, and sought closer ties with Russia. This shift has resulted in a reallocation of resources from public services to military campaigns against jihadist militants. Consequently, government troops, jihadists, and other armed groups are perpetrating increasingly frequent abuses against the rural population. The easy departure of French and UN forces and the entry of Russian mercenaries have further complicated the geopolitics of the Sahel. This situation places the European countries in a dilemma: the regimes are less than perfect partners, but they are the primary interlocutors in the region. The military regimes of the Sahel adopted single-minded military approaches and, at most times, rubbished multidimensional strategies promoted by Western partners and the UN. Although military operations against jihadists and, in the case of Mali, against non-jihadist rebel groups have increased, the security situation is still gloomy, with widespread violence and mass killings. The security gains from the new defence policies of the three countries are very little, and insecurity continues to characterise the region. The new regimes created the Alliance of Sahel States—a mutual defence arrangement—which shows their intention to entrench themselves and withstand external pressures. Though hostile towards France, the regimes have kept good diplomatic relations with the EU and remain recipients of humanitarian and development aid. The EU finds itself in a tight corner, as member states are sharply divided over what to do regarding the new situation. While some member states are for the continuation of engagement with regimes in the Sahel, others would scale down their relations. The Sahel strategy defined in the past decade is no longer up-to-date and needs at least considerable adjustments. What the EU has to balance is its aspiration to influence the region by staying close to local actors and adherence to principles it has set—like respect for human rights. In the State of the Union address of September 2023, Ursula von der Leyen insisted on a new European strategic approach for Africa consisting of cooperation with legitimate governments and regional organizations. In the Sahel, this call comes at a time when the EU seems to be losing momentum in its efforts to influence regional developments (Crisis Group, 2024a).

The Sahel region remains marked by a very hostile security situation, with deadly attacks, internal strife, and shifting international alliances. Burkina Faso suffered one of the deadliest attacks on its military on June 11, 2024, after the al-Qaeda-affiliated Group for the Support of Islam and Muslims (JNIM) raided a military base in Mansila, Sahel region, near the Niger border. The attack claimed more than 100 soldiers, widening the rupture within the military ranks and fuelling fears of instability for the regime. Other attacks attributed to JNIM were deadly and targeted civilians and military auxiliaries, further destabilising the country. Rumours of a mutiny following the Mansila attack, with artillery fire subsequently ringing out in Ouagadougou, further exacerbated the internal turmoil. The government has continued to stifle international press freedom, most recently with the suspension of TV5Monde after its accusations against regime laxity on jihadist threats. Relations with Russia deepened with a visit by Russian Foreign Minister Lavrov to Ouagadougou aimed at discussing ongoing military cooperation (Crisis Group, 2024c). In Mali, huge labour unrest forced the freeing of a key union leader after he was arrested, a sign of continuing friction between the government and civil society. The political repression continues, with many political leaders having been arrested during a private meeting of opposition groups. Fractures appeared between the military authorities and the civilian prime minister, Maïga, and violence continues to strike the country in bursts. There have been reports of clashes between al-Qaeda-affiliated groups and Islamic State Sahel Province commanders, while military operations are also taking place against a myriad of armed factions. The relations with international actors are changing too, as, for example, Sweden closed its embassy in Mali and set Senegal as a regional hub for its activities (Crisis Group, 2024c). Relations between Niger and Benin remain strained following the arrest by the Beninese authorities of Nigerien oil workers, which led to the blockade of Nigerien petroleum exports and mutual accusations of espionage. Supporters of the ousted President Bazoum attacked infrastructure facilities, including the Niger-Benin pipeline, causing huge casualties and disruptions. There have also been military clashes and attacks on civilians, such as in the case of jihadist violence in the Diffa and Tillabery areas, which has continued unabated. In turn, Niger is realigning its international military alliances by meeting with top Russian officials to discuss a potential deal while overseeing the withdrawal of US troops (Crisis Group, 2024c).

Horn of Africa

The human rights situation in Eritrea remains a cause for international concern. In a report by the UN special rapporteur dated June 20, 2024, Mohamed Babiker expressed that Eritrean authorities demonstrate very little political will to address continuing human rights violations. These violations include indefinite and compulsory national service, repression of religious freedoms, inadequate rule of law, and violations of both civil and political rights. In addition, Eritrea has been suppressing dissenting voices within the diaspora (Babiker, 2024). The Eritrea-Russia relationship has improved, particularly in terms of military cooperation, with an increase in Russian naval presence in the Red Sea against Western influence (Crisis Group, 2024c).

Unrest and violence plague Ethiopia, particularly in the Amhara and Oromia regions. In Amhara, there have been reports of ongoing conflicts between the federal forces and the nationalist militia Fano. Military command posts established at different levels are still operational even after the expiration of the state of emergency on June 3, 2024. On June 24–25, the state hosted a peace conference in Bahir Dar, where a 15-member Regional Peace Council was instituted, mandated to engage in dialogue with Fano militias. Violence between

Fano militants and the Oromo Liberation Army (OLA) has also dramatically increased in Oromia, with significant civilian deaths and heightened inter-ethnic tension. Territorial disputes between the federal government and Tigray, as well as Amhara, over the latter's desire to annex Western and Southern Tigray are also yet to be resolved, with increased violence—especially over federal plans to dismantle Amhara-established administrations in the two areas and resettle displaced Tigrayans (Crisis Group, 2024c).

For Somalia, 2024 will be a defining year: its campaign against the insurgency of Al-Shabaab has stalled, and political tensions are rising ahead of state-level elections. The planned drawdown of the African Union Transition Mission in Somalia (ATMIS) complicates the security landscape, as the Somali forces are not ready to take on full security duties. While the Somali government has had several successes against Al-Shabaab, the insurgency has nonetheless remained resilient, with guerrilla tactics continuing to hinder government efforts. Stabilisation efforts in recovered areas have been painfully slow, with basic services and security remaining difficult for the government to deliver. The state-level elections in 2024 will further complicate Somalia's complex political environment, reigniting both political and clan tensions. The opposition camps are sceptical about the government's commitment to compiling a draft constitution and comprehensive electoral reforms. The humanitarian situation is still precarious because of climate change and old conflicts. More recently, a new crisis cropped up when neighbouring Ethiopia announced that it had signed an agreement with the breakaway state of Somaliland to lease a chunk of land on the Gulf of Aden, to which Mogadishu has objected. Despite these challenges, Somalia has pulled off quite significant milestones on the international scene: the UN's arms embargo was finally lifted, and a debt relief programme was brought to completion. However, domestic challenges persist. The offensive against Al-Shabaab has lost momentum, and the government struggles to consolidate gains in recovered areas. The drawdown of ATMIS forces puts a question mark over the ability of Somali forces to hold their ground. Somalia's government has proposed a follow-on mission to ATMIS, aimed at securing key areas and providing training and logistical support to local forces, but details of the mission and how it would be funded are still lacking (OCHA, 2024c). The EU has been an important partner to Somalia, as it has invested €4.3 billion since 2007 into the country, mainly in security. In May 2023, a joint roadmap was adopted, placing emphasis on inclusive politics, security, stabilisation, and socio-economic development. This plan largely depends on the security situation in Somalia (Crisis Group, 2024a).

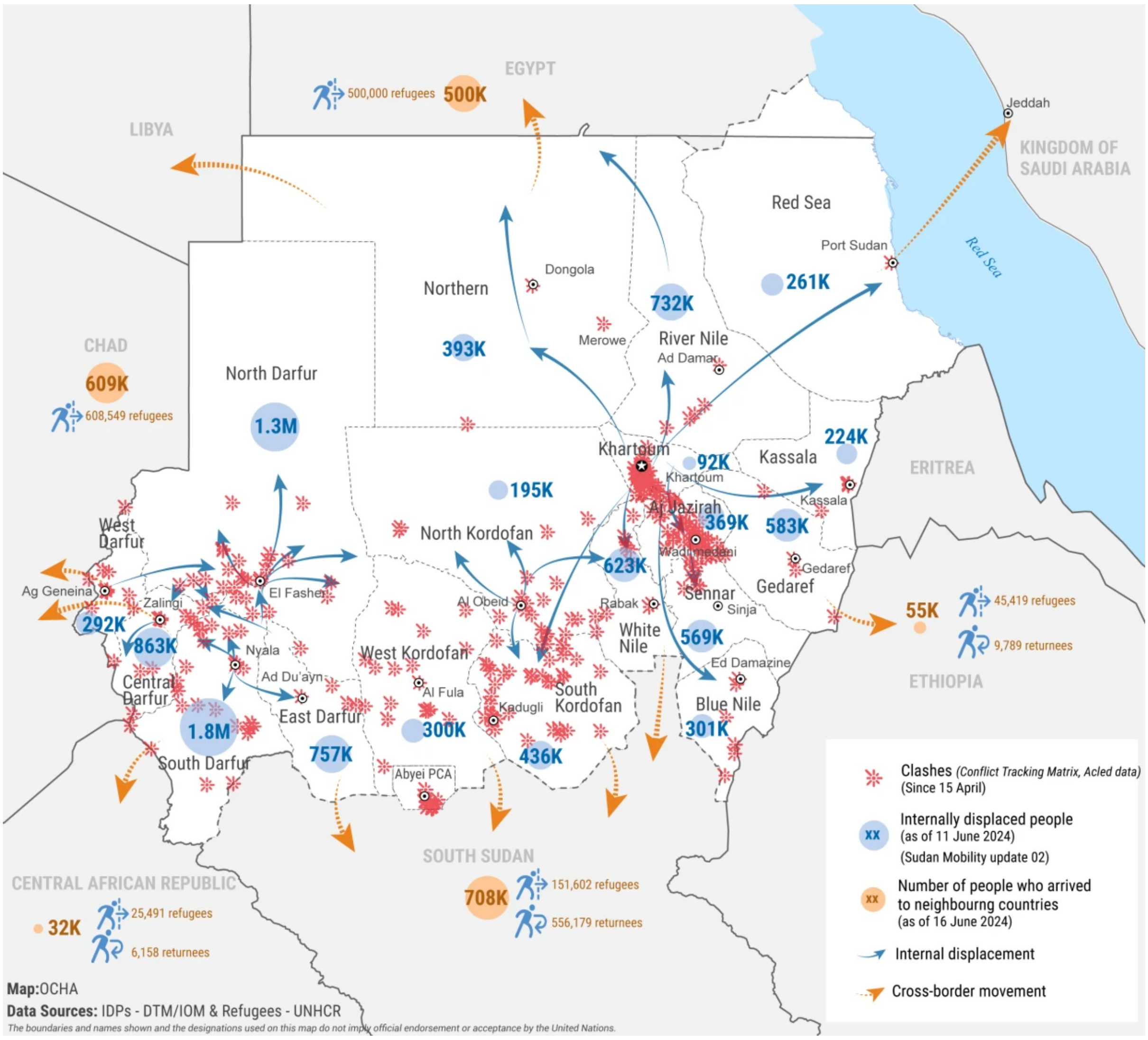
Somaliland is gearing up for elections on November 13, 2024, amidst boiling political temperatures. Allegations of bias among the National Election Commission, rows over electoral technology, and arrests of opposition supporters raise the risk of election-related violence (Crisis Group, 2024c).

In South Sudan, Kenya-led peace talks came up with a draft agreement that could resolve ongoing conflicts, but the opposition of Vice President Machar showed internal divisions. Its economic crisis had already been dire due to the breakdown of a crucial oil pipeline and has further deepened with efforts at securing international loans that are highly troubled (Crisis Group, 2024c).

The catastrophic war in Sudan, which erupted back in April 2023, has passed the one-year mark with no end in sight. The conflict pits the Sudanese army led by General Abdel Fattah al-Burhan against a paramilitary group called the Rapid Support Forces (RFS), commanded by Mohamed Hamdan Dagalo, known as Hemedti. As shown in Figure 4.2 this war has destroyed much of the capital, Khartoum, and claimed tens of thousands of lives, with nine million displaced and millions pushed to the brink of starvation. Both sides, but particularly the army, obstruct food aid, and these actions are fast pushing Sudan to famine. Mediation efforts are disjointed, and external states backing opposing sides are exacerbating the conflict. The urgency of ending the war is paramount; the longer the conflict continues, the harder it will be to resolve due to the country's internal fragmentations and the involvement of more and more armed groups. The humanitarian crisis is dire and worsens daily (OCHA, 2024f). The conflict in Sudan erupted barely months after the overthrow of Omar al-Bashir's 30-year dictatorship. The struggle for power between the army and the RSF—both legacies from Bashir's regime—escalated after the army reinstated officials from Bashir's era to counter Hemedti's rising influence. The RSF was initially dominant, easily taking over much of Khartoum and large territories in both Darfur and Kordofan. In 2024, the momentum shifted as the army made major gains thanks to Iranian drones and airstrikes. The conflict is now, however, locked in a stalemate, with both sides needing time to regroup. The war has fragmented both main belligerents. Burhan relies on ex-Bashir and Islamist elements and various militias, risking losing control over these factions. The RSF has become a collection of tribal militias and warlords, motivated by plunder and local objectives, making wartime coalitions increasingly unmanageable. This has exacerbated inter-communal tensions, leading to mass killings and displacements, especially in Darfur, where Arabs and non-Arab groups are clashing. The recruitment by the RSF based on ethnic lines and atrocities on both sides have deepened these divides. Sudan faces one of the worst humanitarian crises in recent memory: famine looms, and acute food insecurity affects millions. The obstruction of aid by the army and RSF, especially in areas held by the RSF, worsens the crisis. The regional dimensions of the conflict are also outstanding, as the involvement of neighbouring states and external powers—including Egypt, Iran, and the UAE—also has complicated prospects for resolution, raising the possibility of spillovers into Chad, South Sudan, Ethiopia, and Eritrea. Jihadist groups might seize the opportunity to get a foothold on the ground. The mediation efforts failed partly because Burhan has been reluctant to enter into peace talks. It is reported that the United States and Saudi Arabia have scheduled a third round of negotiations in Jeddah, which will bring together Egypt, the United Arab Emirates, the African Union, and IGAD. The army continues to vacillate about attending these stalled talks. An attempt by IGAD flopped after the government protested an invitation offered to Hemedti to attend the IGAD summit. The current diplomatic drive, encompassing new US and UN envoys and an AU high-level panel, finally brings the promise of more serious engagement. So far, however, these various efforts have been incoherent and not urgent, and the cast of international actors remains fragmented. The humanitarian response remains the top priority, led by the EU and its member states in terms of meeting aid pledges and making sure that the most vulnerable populations get the necessary aid. The implosion of Sudan would have catastrophic humanitarian and security consequences, particularly destabilising the Red Sea and Sahel regions and possibly opening up a safe haven for jihadists.

Urgent action is vital to mitigate the human toll of violence and famine and to prevent large-scale instability in the Horn of Africa (Crisis Group, 2024b).

Figure 4.1 The situation in Sudan (OCHA, 2024f)



Middle East

The Israeli-Palestinian conflict has plunged into one of its most turbulent and deadly phases, marked by a major humanitarian crisis in Gaza. In the early hours of October 7, 2023, Hamas launched a surprise attack on southern Israel, killing over 1,100 Israelis and kidnapping nearly 250 hostages, including civilians. In response, the government of Israel opened a massive military operation against Hamas in Gaza. In June 2024, military operations in the West Bank and Gaza Strip were increased by Israel. The Israeli government announced its intention to legalise five settlement outposts in the West Bank, furthering the alarming surge in violence and concern from the international community, including the UN Security Council. Several deadly raids were carried out by the Israeli forces, with a focus on the killing of six Palestinians in Kafr Dan and the launch of an airstrike in the Nur Shams refugee camp. Military operations by Israel in Gaza went on to kill over 1,500 Palestinians in June alone, making it at least 38,000 since October. Notable operations in the Nuseirat refugee camp succeeded in releasing four Israeli hostages but killed 274 Palestinians (Crisis Group, 2024c). A proposed ceasefire called for by US President Biden failed to take off as negotiations stalled, and finally, the war cabinet in Israel was dissolved due to internal political strife. The situation in Gaza is simply humanitarianly catastrophic. Around 85% of its population has been displaced at least once, and 60% of the civil infrastructure has been demolished. The blockade, which Israel has imposed unilaterally since the beginning of the conflict, has cut off water and electricity and severely restricted the supply of food, which leads to massive starvation and the possible proliferation of infectious diseases. The economic outlook for Gaza remains dire. Before this conflict, 60% of Gaza's food was obtained through imports and the remainder from local production. Military actions have since destroyed the agricultural sector, and the blockade has disrupted imports, leading to food insecurity at extremely high levels. According to the Famine Review Committee last December, 17% of Gaza's population was at catastrophic levels of food insecurity, while 42% were at the emergency threshold. With a lack of fuel, medical services are being brought to their knees, with only thirteen out of the thirty-six hospitals in Gaza partially operational as of early January. Now, telecommunications shutdowns have come to compound this humanitarian crisis by affecting aid distribution (OCHA, 2024g). In addition to this, the conflict has not remained within the boundaries of Gaza. Israeli army raids and settler violence in the West Bank have risen manifold. The war has seeped into Lebanon, Syria, and Iraq. An attack by Iran-backed militias on January 28, 2024, killing three US servicemen on the Jordan-Syria border, expanded the battlefield. The United States is preparing to mount a sustained campaign of military force against Houthi rebels in Yemen, who have set their sights on Red Sea shipping. The longer the war rages, the greater the risks of regional escalation and instability will grow. Military objectives set by Israel—to eliminate Hamas and secure the release of hostages—already seem unreachable. Despite the relentless bombing by the IDF, Hamas' military wing persists in its response by launching hundreds of rockets into Israel and attacking Israeli soldiers who entered Gaza on foot. Even as Israel manages to reduce the potential of Hamas to a minimum, deep-seated anger and a feeling of revenge among Palestinians, due to decades of occupation and siege, ensure that resistance will not be extinguished. The devastation visited upon Gaza only made its residents more determined to resist. Lasting peace can only be secured by negotiation, which involves respect for Palestinian rights and aspirations towards self-determination. But the government of Israel, led by Prime Minister Benjamin Netanyahu, denied them this aspiration. The ICJ ordered that, pending final judgement, the State of Israel should immediately take all measures necessary to prevent all acts of genocide, punish persons charged with these acts, and further take all measures necessary to permit humanitarian assistance. Yet, there are no means of enforcing it in the international court, and Israel continues to pursue its military operations. The regional repercussions of the conflict are grave. Hezbollah launched attacks into Israel from Lebanon, causing mass displacement in northern Israel. The situation escalated to near full-scale war by June 2024, with Hezbollah and Israel launching heavy cross-border attacks against one another. An Israeli airstrike on southern Lebanon killed key members of Hezbollah. Major rocket and drone attacks fired at northern Israel by Hezbollah caused injuries and wildfires. On both sides, threats escalated, with Israeli officials threatening an all-out war and Hezbollah leader Nasrallah warning of war without restraint. The Iran-backed militias have struck US forces in both Iraq and Syria, drawing US retaliatory strikes that push relations with Baghdad to a breaking point. In Yemen, the Houthi rebels have struck against shipping in the Red Sea, provoking a United States-led naval coalition to guarantee safe passage. Any of these conflicts can easily go out of control, though neither Iran nor the United States want a broader regional war. Hezbollah has refused to consider any deal with Israel until a permanent ceasefire is in place in Gaza. At this stage, a long and ruinous conflict between Israel and Hezbollah cannot be excluded. The crisis of political leadership on the Palestinian and Israeli sides problematizes further efforts towards resolution. The Palestinian Authority (PA) is seen as ineffective and subservient to Israeli interests; at the same time, the Israeli government suffers from internal crises, and public dissatisfaction with its policies on the conflict grows. But Prime Minister Netanyahu, under pressure from corruption charges and mass protests, has little incentive to end the war, which could threaten his political survival. Israel's Western allies, while uncomfortable with its conduct, have done little to restrain it. The US continues to sell arms without appreciable conditionality, and the EU's calls for a ceasefire have no collective endorsement. Attention must also be focused on the West Bank. It is important to advocate for the cessation of settlement growth and to take strict action against the perpetrators of settler violence (Crisis Group, 2024a).

Lebanon's economic crisis and political deadlock continue, with authorities failing to make any headway towards ending a double executive vacuum or implementing necessary reforms to unlock an IMF financial rescue package. A shooting near the US Embassy in Beirut heightened tensions. Since the Gaza war broke out in October 2023, Hezbollah and Israel have been gradually escalating hostilities, expanding the territory under fire, and diversifying the kinds of weapons used. While, to date, both parties have succeeded in preventing an all-out war from breaking out, the risk of an escalation remains high. US and French mediation efforts have been in the works, but Hezbollah says it will continue the fighting until Israel halts its Gaza campaign. This conflict has displaced more than 100,000 Lebanese and a similar number of Israelis, placing civilians in both countries at great risk. Further escalation will suck both parties into a wider Middle East conflict, quickly escalating into a regional war potentially involving Iran. The war of attrition between Israel and Hezbollah is being fought with increasingly aggressive tactics. Bombardments, which were at first restricted to small areas, often uninhabited, have opened up: Israel strikes deeper into Lebanon, including sites in Baalbek and Hermel, while Hezbollah has attacked up to 35 km south of the border. Hezbollah has added more advanced weaponry, guided anti-armour rockets, and attack drones to its arsenal, attesting to the ability of Hezbollah for complex operations (Crisis Group, 2024b). Both parties appear keenly interested in avoiding civilian casualties, yet the risk of a tactical mistake or strategic misjudgement is high when the conflict zone is widely spread. The situation is further complicated by the political pressures within Israel, as displaced civilians demand stronger military actions against Hezbollah. Should the efforts to return calm through diplomatic channels fail, then Israeli leaders could well step-up military operations, risking an all-out war that would cause unprecedented damage to both countries. An all-out attack by Israel on Hezbollah can provoke an overwhelming response on the part of Hezbollah, which will include long-range missiles targeting crucial facilities in the State of Israel, such as nuclear infrastructure. Thus, the conflict will spread to involve patrons—the US and Iran—and a regional war with huge repercussions. It thus becomes incumbent upon the European states to further their diplomatic efforts in order to defuse this highly dangerous situation. It is not only a step to alleviate the suffering of Palestinians but also to forestall further regional conflicts by ending the war in Gaza. To this end, member states should support diplomatic efforts for a ceasefire in Gaza and use their influence to work toward a halt in hostilities, even in the absence of a European Union consensus on how to apply pressure on Israel. If a solution for Gaza could be found, this could open the door for new security arrangements in southern Lebanon that satisfy some of Israel's concerns. There, Hezbollah has shown some willingness to engage in post-ceasefire negotiations. In particular, the Lebanese army will require important assistance to ensure the effective deployment of troops along the border. Some support has already been provided by the EU through measures by member states and through the European Peace Facility, but additional support will be indispensable. UNIFIL, the international peacekeeping force in southern Lebanon, also needs increased financial and troop support from Western countries. In addition, European countries should plan for the possible humanitarian consequences that could result from an all-out war between Israel and Hezbollah. Anticipatory humanitarian action must, therefore, facilitate NGOs and agencies to scale up operations in overstretched Lebanon. A major refugee crisis of this nature could mean that many will sail to Cyprus and Greece or go by land to Syria. Proactive EU engagement in diplomacy and humanitarian preparedness is the key to minimising the risks of the escalation of a war between Hezbollah and Israel. European efforts to end the war in Gaza and to prepare for humanitarian consequences can help contain the situation and prevent further ruinous wars in the future (Crisis Group, 2024b).

In June 2024, there was an increase in Israeli airstrikes against Iran-backed militias in Syria, killing dozens of combatants, including high-ranking officials. These were in retaliation for the continuous drone attacks by Iranian-backed groups on US bases. The Islamic State (ISIS) continues to be operative, with attacks resulting in significant casualties among Syrian government forces. In northeast Syria, the Kurdish administration delayed municipal elections due to threats from Turkey and internal strains. In southern Syria, local armed factions detained security officers in order to secure the release of a detained civil society activist (Crisis Group, 2024c).

An Iranian presidential election to replace the late President Raisi occurred in June 2024, which all reports suggested had the lowest voter turnout on record, and no candidate won an outright majority, so a runoff is scheduled. The International Atomic Energy Agency voted to censure Iran for non-cooperation, to which Tehran reacted by increasing its capacity to enrich uranium. The move elicited warnings from the United States and brought further sanctions by both the United States and Canada against Iranian individuals and entities involved in terrorism and other illegal activities. Despite increased Western pressure, Iran's internal political dynamics and nuclear advancements continued to strain international relations (Crisis Group, 2024c).

Iran-backed groups in Iraq claimed a number of drone attacks targeting sites in Israel, which Jerusalem never confirmed. The same groups attacked the headquarters of American entities in Baghdad, accusing the US of standing behind Israel. The Kurdish Democratic Party (KDP) agreed on parliamentary elections with Iraq's Federal Supreme Court, a breakthrough towards solving electoral conflicts in Kurdistan. Military operations by Turkey against the PKK (Kurdistan Workers' Party) in northern Iraq continued unabated, with the extension of a flight ban to Sulaymaniyah airport over alleged PKK activities. Relations between Baghdad and Erbil improved, a development that paved the way for progress in regional governance (Crisis Group, 2024c).

In Yemen, June 2024 saw a rise in Houthi attacks against shipping in the Red Sea. A Greek-owned vessel sank, with several people injured. The US launched airstrikes with the UK against Houthi sites that pose a threat to maritime activities. On the local level, mediators managed to reopen the critical road between Sanaa and Taiz, which had been closed for a decade. However, the Houthis detained 60 aid workers, raising tensions with international organisations and jeopardising further humanitarian aid disruptions. Meanwhile, clashes between Houthis and the Southern Transitional Council in Lahj governorate underlined internal conflicts (OCHA, 2024b; Crisis Group, 2024c).

Turkey continued its military operations against the PKK across Iraq, Syria, and the southeast of the country. Authorities also targeted suspected ISIS supporters, underscoring ongoing counter-terrorism efforts. Diplomatic initiatives included potential BRICS membership and normalisation talks with Greece and Syria, despite ongoing maritime disputes with Greece (Crisis Group, 2024c).

Balkans

Bosnia and Herzegovina stands at its most precarious moment in years, with one of its two ethnically divided parts, Republika Srpska (RS), steadily charting a course towards secession. The tension is primarily political, with RS leaders rejecting the authority of Sarajevo and the international High Representative, Christian Schmidt. That crisis blew up just weeks after the European Union agreed to open accession talks with Sarajevo. The situation is politically driven as everything revolves around the control over the elections at a local level due to take place in October, which the leaders of the RS want to conduct themselves outside the control of the High Representative. RS President Milorad Dodik sought support from Russia, Serbia, and Hungary, hinting that independence will be pursued in case global geopolitics breaks in their favour, for example, a second term for Donald Trump. The strategy of Dodik also envisages the adoption of laws in RS that reject all future decisions of the constitutional court and the High Representative, which aggravates the conflict. Although the leadership of RS has undertaken actual steps affirming its autonomy, for example, by adopting its own election laws, it is very cautious not to provoke an international response. While the crisis could well escalate into violence, especially in ethnically mixed areas, it is unlikely in the near term. What the EU and member states have in the way of leverage should be used to ensure things do not get any worse than they already are. This includes an agreement whereby RS would end unilateral election efforts in exchange for the High Representative to agree that he would refrain from punitive measures and Bosnian parliament's enactment of a new election law. Coordination with the US and other key actors is essential to presenting a unified approach to the High Representative. The Dayton Peace Agreement, which ended the Bosnian war in 1995, provided for a nominally sovereign central government with limited powers that were frequently in conflict with the RS over authority. These unresolved tensions underpin the current standoff between Dodik and Schmidt, with RS taking steps for independence while waiting for an opportune moment to break away fully. This has included legislative measures that undermine the central government’s authority and statements that provoke ethnic and political divisions. The influence that the EU has and the promise of accession benefits should be used to pressure RS into compliance and discourage further unilateral actions. These also include the remaining issues from the Dayton Agreement that are necessary for the closing of the High Representative’s office. Parallel to the political crisis is an emotional controversy about a UN General Assembly resolution that condemns the Srebrenica genocide. This resolution is seen by most Serbs as a measure to stigmatise them, which Dodik has exploited to galvanise Serb opposition to the central government and international supervision. The controversy has advanced further divisions and has played into Dodik’s hands as part of his strategy to present RS as a victim of international injustice. In this respect, careful and coordinated international efforts should be required to avoid the disintegration of the state of Bosnia and Herzegovina. The EU has to do its best in mediating the conflict while at the same time using the above leverages to induce stability and respect for the Dayton framework, while also preparing the ground for the eventual closure of the High Representative’s office. It should give way to a political climate where Bosnia would be able to function independently, having the capacity to pursue membership in the EU without threats from secession movements (Crisis Group, 2024b).

Pressure from Kosovo’s Prime Minister Albin Kurti, in office since 2021, has been growing in the four northern municipalities where ethnic Serbs are the majority. At the core of the dispute between Kosovo and Serbia lies Pristina’s refusal to allow greater autonomy for the Serbian population and Belgrade’s denial of Kosovo’s independence, proclaimed in 2008. These issues block Kosovo's path towards membership in international associations like the EU and UN. The two countries have permitted a kind of overlap in their sovereignty over the north: Serbia provides schooling and healthcare, while Kosovo is responsible for law enforcement and the judiciary. Kurti’s government has increasingly asserted its authority by deploying heavily armed police, imposing embargoes on Serbian goods, evicting Serbian institutions, and banning the use of Serbian currency. These measures, justified by security concerns such as the discovery of Serb paramilitaries smuggling military-grade weapons in September 2023, have led to significant flights from Kosovo’s Serbs. More than 10% of Kosovo’s Serbs emigrated in the last year, stepping up an eight-year trend during which as many as one-third have left (Crisis Group, 2024a). The flight of the Kosovo Serbs undercuts possible paths to normalisation, which might involve Kosovo granting far-reaching self-rule to its Serbs in return for Serbia’s *de facto* recognition. To help these dynamics, the EU needs to encourage Kosovo to police according to community needs rather than militarised deployments, ensure that northern Serb needs are met, and press Serbia to full cooperation in curbing arms smuggling. The question of governance within the Serb-majority northern municipalities has been contested since the 1999 conflict. The modus vivendi tolerated parallel systems, with Serbia and Kosovo delivering overlapping services. However, the modus vivendi was broken by the new government led by Kurti, which resulted in boycotts, resignations, and violence. A key incident in September 2023 was the fatal confrontation between the Kosovo police and Serb paramilitaries near Banjska, which epitomised how high the tensions are running and cost Serbia Western sympathy. Such pressure tactics by Kosovo can easily lead to more violence and worsen the chances of a long-term resolution. A compromise in the form of considerable self-government for Serbs in return for Serbia's recognition still stands as the most plausible route to normalization. This potential solution is further confounded by the fact that Kosovo's Serb population is shrinking. The minority of northern Kosovo Serbs feels increasingly insecure, and the pressure campaign Kurti launched against them in 2021 did not help matters. Kosovo police are ethnic Albanians who speak no Serbian, further adding to these fears. Although violent crime rates in the area are very low, the modest policing needs of the Serb community are ignored, and the police concentration is rather oriented towards minor offences such as smuggling, seizing Serbian-built properties, and operating from fortified bases that resemble occupying forces. Kosovo should reorient its policing policy in the Serb areas, restricting special police operations to border security and arms tracking while making sure that regular police are Serbian-speaking and conduct outreach within the community. Also, the Ministry of Internal Affairs should ensure that police stations in Serb regions offer necessary services to the community. Any effective response to the situation in northern Kosovo must take account of both the threat from Serb paramilitaries and the excessive police presence. To counter this security risk, the EU should pressure Serbia into cooperating with Kosovo and KFOR in blocking further arms smuggling across the border and helping KFOR neutralise any cache of military-grade weapons already in the country. If Belgrade behaves, then the EU will have no basis for imposing sanctions or other punitive measures comparable to those it imposed in June 2023 on account of the Kurti administration's failure to honour its commitments to the Community/Association of Serb municipalities and its harsh treatment of the northern Serbs. In return, the EU could offer to lift those measures from Pristina if it gradually withdraws its special police from Serb-majority areas and reorients the remaining officers from enforcing government authority to providing public safety. Recently, Kosovar and Serb leaders failed to resume EU-mediated talks on normalising relations amid criticism over the Kosovo government's plans for the expropriation of land in Serb-majority northern Kosovo. The EU-mediated meeting on June 26 between Kosovar PM Kurti and Serbian President Vučić was cancelled, according to EU High Representative Joseph Borrell, because Kurti refused to go since Vučić failed to meet the conditions laid down, among them the handing over of Milan Radoičić, a key Kosovo Serb involved in clashes with Pristina's forces in 2023. Borrell said the leaders "remain far apart" on normalisation (European External Action Service, 2023), but the chief negotiators are scheduled to meet in Brussels in early July. Furthermore, on June 6, international actors—the Quint states, OSCE, and EU—condemned Pristina for furthering the expropriation of over 100 parcels of land in northern Serb-majority municipalities. Pristina explained that the move was necessary for infrastructure, namely police stations, to guarantee citizens' safety from violence coming from criminal gangs headed by Radoičić (Crisis Group, 2024a; Crisis Group, 2014c).

Caucasus

June 2024 continued to see disagreements between Armenia and Azerbaijan over two core peace process issues: the withdrawal of troops and constitutional amendments. While both countries exchanged draft peace treaties, deep differences have emerged, further inflamed by incidents on their border. Armenia attempted to integrate with the West by conducting strategic dialogues with both the US and the EU against a cooled backdrop of relations with Russia. Domestic protests and legislative initiatives have underscored the internal challenges facing Yerevan with the development of a new constitution. Azerbaijan's stance over Armenia remained quite uncompromising, with the peace process reaching a standstill due to contentious issues. Several incidents occurred along the frontline, with both sides accusing each other of violations. Domestically, Azerbaijan announced snap parliamentary elections and continued its efforts at strengthening international relations by holding joint military exercises with Iran and conducting defence talks with Western allies (Crisis Group, 2024c).

Georgia approved the very controversial 'foreign agents' legislation, prompting significant backlash from Western nations, including visa restrictions and downgraded political contacts from the US and the EU. Competitive legislative elections were also held in South Ossetia, which Georgia and its Western allies branded as illegitimate. These developments signal a challenging period for Georgia's international relations and domestic politics (Crisis Group, 2024c).

In June 2024, Russia saw a terrorist attack in Dagestan that resulted in large-scale casualties. President Putin repeated his maximalist conditions for a cease-fire with Ukraine, which were promptly rejected by Kyiv. The US allowed Ukraine to use US weapons on Russian soil to protect the Kharkiv region; this promise by the US elicited threats from Russia of an asymmetric response. Meanwhile, Western sanctions ratcheted up as Russia continued to cement relationships with rogue states, which included a defence pact with North Korea (Crisis Group, 2024c).

Eastern Europe

Belarus held further nuclear exercises with Russia and faced international condemnation for its human rights record. The United Nations pointed out the deteriorating situation, and the US designated Belarus a state sponsor of human trafficking. Closely related to that have been regional tensions underlined by border fortifications and trade restrictions from neighbouring countries and the EU, reflecting increasing isolation (Crisis Group, 2024c).

Moldova advanced its EU accession talks in June 2024, following the European Commission's confirmation that it met the necessary criteria. At the same time, the US imposed sanctions on the pro-Russian governor of the Gagauz autonomous region, indicating a continued geopolitical tug-of-war in the region (Crisis Group, 2024c).

The ongoing conflict in Ukraine, initiated by Russia's invasion in 2022, has reached a stalemate with no immediate resolution in sight. Despite a significant counteroffensive by Ukrainian forces in the summer of 2023, the battle lines remain largely unchanged. Ukrainians remain united in their resistance against Russian terms that would turn Ukraine into a vassal state. Western support, crucial for Ukraine's defence, faces increasing scrutiny, especially with political changes in the US and Hungary's potential to block aid within the EU. Western states have provided substantial military and financial support to Ukraine. However, the upcoming US presidential election and Hungary's opposition to aid packages pose significant challenges. The EU needs to prepare for potential decreases in US support by increasing its own military production and assistance to Ukraine. The EU must work on institutional reforms and commit to long-term funding for military supplies while revitalizing European weapons manufacturing. Additionally, the EU should adapt training programs for Ukrainian troops to battlefield realities, incorporating feedback from Ukrainian commanders and non-military support for veterans. Supporting Ukrainian exports while mitigating competition fears in EU border states is also crucial. Ukraine faces challenges in maintaining troop strength and managing political conflicts within its leadership. The economy, although growing, is strained by war, with significant workforce shortages and infrastructure under pressure from increased exports and border congestion. Kyiv's ability to hold off Russia and secure a lasting peace depends on sustained Western support. The EU's strategic investments in military and economic aid, coupled with diplomatic efforts, are essential for Ukraine's resilience and the broader stability of Europe (Crisis Group, 2024a). In recent updates, Ukraine managed to contain a Russian ground assault in the Kharkiv region but continues to face persistent Russian airstrikes targeting its cities and infrastructure. President Zelenskyy hosted a peace summit in Switzerland, aiming to rally international support for his ten-point peace formula. The summit saw limited success with key non-Western countries absent from the communique. Nonetheless, foreign partners, including the G7 and the EU, have bolstered their support for Ukraine with significant financial aid and security agreements. Russia's war in Ukraine has become a long standoff, with neither side making significant territorial gains. Despite successes in air defence and remote strikes on Russian forces, Ukraine's primary goal of severing the Russian-controlled land corridor remains unmet. Moscow, too, has been unable to advance significantly, although it continues to launch aerial attacks on Ukraine's infrastructure. Both countries are striving to prepare more soldiers, accumulate ammunition, and fortify positions, demonstrating their resolve to continue the conflict. Russia, with its larger reserves of arms and enlistees, appears to be in a stronger position. Despite high inflation, Putin has reconfigured the economy to prioritize military needs, and Western sanctions have not significantly hindered Russia's ability to fund its war effort. Ukraine, on the other hand, relies heavily on Western assistance. Ammunition and weaponry are top priorities for Kyiv, particularly as it shifts to a primarily defensive strategy. Maintaining effective air defences and troop strength are critical concerns, as volunteer numbers dwindle and conscription becomes more stringent. Ukraine's economy, though recovering, continues to be battered by the war. The significant number of refugees and the strain on transport infrastructure add to the economic challenges (OCHA, 2024e). Additionally, competition between Ukrainian exporters and neighbouring EU states creates friction. Support for Ukraine in the West is becoming increasingly fragmented. In the United States, political dynamics, election-year politics, and other global conflicts, like the war in Gaza, are diverting attention and resources. In Europe, although political support remains strong, dissenting voices like Hungary's Viktor Orbán threaten to disrupt aid packages. The EU's decision to commence membership talks with Ukraine sends a strong message of political support, but actual membership and security guarantees remain distant prospects. Negotiations remain the most likely endgame for the conflict, but current Russian demands for Ukraine's demilitarization and political subjugation are unacceptable to Kyiv and its Western supporters. The EU and its member states must continue to support Ukraine militarily and economically to ensure that any future negotiations occur on terms favourable to Ukrainian sovereignty and European security. The long-term commitment to military support and the revitalization of European defence industries remains crucial. Reducing Ukraine's dependency on foreign aid by rebuilding its defence sector, improving training programs, and supporting its export economy are essential steps. The EU must manage expectations and prepare for a protracted conflict while remaining open to diplomatic solutions that respect Ukraine's sovereignty and security (Crisis Group, 2024c).

Asia

In North East Asia, China persisted with its assertive maritime activities in the East China Sea, with 104 Chinese vessels reported in Japan's contiguous zone in June. Notably, Chinese Coast Guard vessels entered Japan's territorial waters near the disputed Senkaku/Diaoyu Islands. In response to these provocations, the US and Japan strengthened their defence cooperation, conducting joint military exercises and initiating discussions on defence production and supply chain resiliency. Meanwhile, on the Korean Peninsula, Russia and North Korea signed a new bilateral treaty aimed at bolstering their defence capabilities and cooperation. This move raised international concerns over potential violations of UN Security Council resolutions, particularly regarding North Korean weapons transfers to Russia. South Korea condemned the treaty and threatened to arm Ukraine, signalling a significant escalation in regional tensions. Along the inter-Korean border, both countries engaged in provocative actions, including the use of loudspeakers and balloons, further heightening the risk of confrontation. In the Taiwan Strait, tensions between Taiwan and China remained high. China maintained significant military activity around Taiwan, while the US approved substantial military support to Taipei, including a $360 million arms sale. Both sides exchanged harsh rhetoric, with China threatening severe consequences against Taiwan's independence supporters and Taiwan reiterating its stance against autocracy (Crisis Group, 2024c).

In South Asia, Taliban authorities in Afghanistan participated in a high-level UN-sponsored meeting in Doha, Qatar, marking their first inclusion in such international talks. However, the exclusion of Afghan women and civil society from the meeting drew significant criticism. The security situation in Afghanistan remained volatile, with ongoing attacks by Islamic State-Khorasan Province and other anti-Taliban groups. Afghanistan's isolation deepened in 2023 as Western donors significantly reduced aid budgets, partly in response to the Taliban regime's oppressive policies towards women and girls. Concurrently, sanctions and other economic pressures were maintained. Afghanistan's main trading partner, Pakistan, imposed commercial barriers amid escalating violence by anti-Pakistan militants in the border regions. Alongside Iran, Pakistan expelled hundreds of thousands of Afghan refugees back to Afghanistan, exacerbating the country's humanitarian crisis. Despite limited international assistance, the

Taliban pursued self-financed infrastructure projects, implemented anti-corruption measures, stabilized the national currency, and increased customs revenues. These efforts, together with international aid and assistance, prevented an economic collapse, but the situation remains precarious, especially for vulnerable groups such as women and girls. Afghanistan's humanitarian situation remains dire, with 13.1 million people facing high levels of food insecurity in 2023. Although this is an improvement from the previous year, the UN predicts that food deprivation will increase again in 2024 (OCHA, 2023). While the Taliban have established greater control over the country, resulting in reduced violence, their strict regime and bans on girls' education continue isolating Afghanistan internationally. The Taliban's refusal to compromise on their policies has blocked potential avenues for breaking this isolation, such as lifting sanctions and unfreezing foreign reserves. Despite these challenges, the Taliban have managed to sustain basic state functions and infrastructure projects through increased customs revenues and reduced corruption at customs points. However, tensions with Pakistan over the presence of the Tehreek-e-Taliban Pakistan (TTP) and mass deportations of Afghans by both Pakistan and Iran have exacerbated the humanitarian crisis. The 2024 UN humanitarian plan for Afghanistan requests $3 billion, reflecting the country's severe needs. However, donor fatigue and frustration with the Taliban's policies, particularly regarding women and girls, have led to reduced pledges. A roadmap for Afghan self-sufficiency exists, highlighted by a UN Security Council report recommending pragmatic steps for international engagement with Afghanistan. These steps include easing restrictions on development and technical assistance, restoring international financing for infrastructure projects, and supporting the rehabilitation of Afghanistan's central bank. The UN emphasizes that supporting Afghanistan's path to self-sufficiency is crucial for the welfare of Afghan women and girls. They note that the approach of some European donors who have cut aid to protest the Taliban's discriminatory policies has proven counterproductive. Such measures exacerbate the humanitarian crisis, disproportionately affect women and girls, and strengthen the Taliban's resolve against Western influence. A more effective strategy involves providing sustainable development assistance, even if it means working with the Taliban regime. This strategy includes supporting primary education for girls, maintaining essential services such as electricity and water infrastructure, and enhancing agricultural productivity. Additionally, the EU should establish safer asylum procedures for vulnerable Afghans, allowing them to apply for asylum from within Afghanistan and thereby avoid dangerous migration routes (Crisis Group, 2024a).

In India, Prime Minister Modi secured a third term with a relative majority in parliament. Ethnic violence spread to Manipur's Jiribam district, and anti-Maoist operations continued in central India, resulting in numerous casualties. India-China relations remained strained, particularly following Modi's expressed desire to strengthen ties with Taiwan. In Kashmir, opposition candidates secured victories in the Muslim-majority valley, rejecting the ruling party's candidates. Authorities continued to misuse anti-terror laws to stifle dissent, and militant attacks persisted, leading to multiple casualties among militants and security forces. In Pakistan, amid tensions with Afghanistan, authorities unveiled a new anti-terrorism plan. Militant attacks and faith-based violence continued, particularly in Khyber Pakhtunkhwa, while internal political deadlock persisted with former PM Imran Khan facing multiple charges despite some acquittals (Crisis Group, 2024c).

In South East Asia, the Arakan Army in Myanmar expanded its control in western regions, causing significant displacement. Ethnic armed groups and regime forces continued hostilities in northern and south-eastern areas, leading to further violence and humanitarian issues. In the Philippines, security operations persisted in the Bangsamoro Autonomous Region, targeting various armed groups, and clashes between security forces and communist rebels continued, particularly in Mindanao and the Visayas, resulting in multiple casualties. Tensions in the South China Sea escalated following a violent maritime confrontation between China and the Philippines. The US and the Philippines, along with regional partners, conducted military exercises in response. Vietnam expanded its features on the Spratly Islands, which the Philippines monitored closely. In Thailand, former PM Thaksin was indicted on *lèse-majesté* charges, and the Move Forward Party faced potential dissolution. Proceedings against PM Srettha Thavisin continued, and violence persisted in the deep south, with multiple attacks and casualties reported (Crisis Group, 2024a; Crisis Group, 2024c).

In the Pacific, unrest in New Caledonia sparked by France's proposed electoral reforms subsided somewhat after President Macron suspended the bill. However, tensions remained high with continued protests and violence, particularly following the arrest and transfer of pro-independence leaders to metropolitan France. The situation remained volatile with road barricades, attacks on police, and arrests, fuelling fears of further unrest.

In conclusion, the volatile geopolitical environment surrounding Europe underscores the urgent need for the EU and NATO to substantially increase military spending to safeguard regional stability and security. The ongoing conflict in Ukraine, escalating tensions in the Middle East, and unrest in regions such as the Sahel and Southeast Asia directly impact European security, exposing vulnerabilities that threaten the stability of the region. Additionally, political tensions in the Balkans and Eastern Europe emphasise the need for a unified European approach to strengthening defence capabilities. Bolstering military readiness is essential not only for deterring immediate threats like Russian aggression but also for enabling the EU to address broader strategic vulnerabilities, reduce its dependency on the U.S., and maintain peace on a larger scale. Enhanced defence investments are vital for NATO and the EU to sustain a strong posture amid shifting alliances and intensifying regional conflicts, underscoring the importance of a resilient and self-sufficient European defence strategy.

4.2 Overview of the Macroeconomic Environment

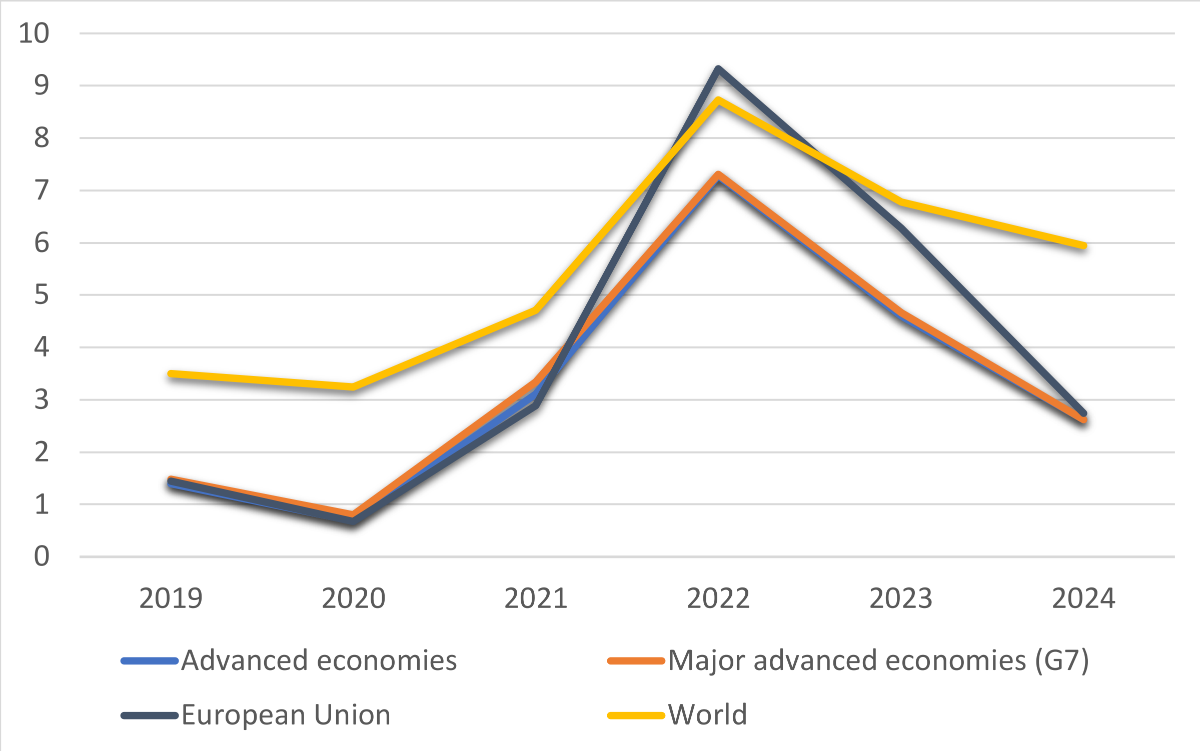
The global economy has demonstrated notable resilience amidst the disinflationary trends of 2022-2023. Despite persistent inflationary pressures and central banks' efforts to restore price stability through elevated interest rates, economic activity and growth in employment and incomes remained steady. During the global disinflation period, economic activity showed unexpected robustness. Employment and income levels held steady, supported by favourable demand and supply conditions in major economies. This stability occurred despite rising central bank interest rates intended to curb inflation. As inflation approaches target levels, central banks are likely to shift towards policy easing. However, the tightening of fiscal policies to manage high government debt, through increased taxes and reduced government spending, is expected to affect negatively future growth prospects.

According to the IMF (2024a) in 2022 and 2023, global real GDP increased by a cumulative 6.7%, surpassing earlier forecasts by 0.8 percentage points. This growth was primarily driven by stronger-than-expected private consumption, especially in the United States and several large emerging markets and middle-income economies. Households in advanced economies utilised pandemic-era savings to sustain their spending, while government spending also exceeded expectations, contributing to aggregate demand expansion. Notably, the US saw additional fiscal support amounting to 2% of GDP, significantly higher than anticipated, while the Euro area's fiscal stance was slightly more expansionary than expected at 0.2% of GDP. The resilience in global economic activity was compatible with falling inflation due to post-pandemic expansions on the supply side. A significant rise in the labour force amid robust employment growth supported both activity and disinflation in advanced economies and several large emerging markets and middle-income economies. The labour force expansion reflected, in some economies, increased inflows of migrants and higher labour force participation rates. Exceptions to this pattern were China, where labour market weakness was broad-based across sectors, and lower-income countries, where supply-side challenges hindered job creation.

Inflation Trends

Headline inflation showed significant declines across most economies by the end of 2023 (see Figure 4.2). Advanced economies saw inflation rates fall to 2.3% on a quarter-over-quarter annualised basis, a sharp decrease from the 9.5% peak in the second quarter of 2022. For emerging market and developing economies, inflation dropped from a peak of 13.7% to 9.9% over the same period, although the average was skewed by high inflation in a few countries. For the median emerging market and developing economy, inflation decreased to 3.9%. Global headline inflation is projected to decline from an annual average of 6.8% in 2023 to 5.9% in 2024 and 4.5% in 2025. Advanced economies are expected to see a more rapid decline, with inflation rates nearing their pre-pandemic average of 2.0% by 2025, a year before emerging markets and developing economies return to their pre-pandemic average of 5.0%. However, significant regional variations are expected, particularly among emerging markets (IMF, 2024a).

Figure 4.2 Average consumer prices trend (annual percent change)



Elaboration on IMF 2024 data.

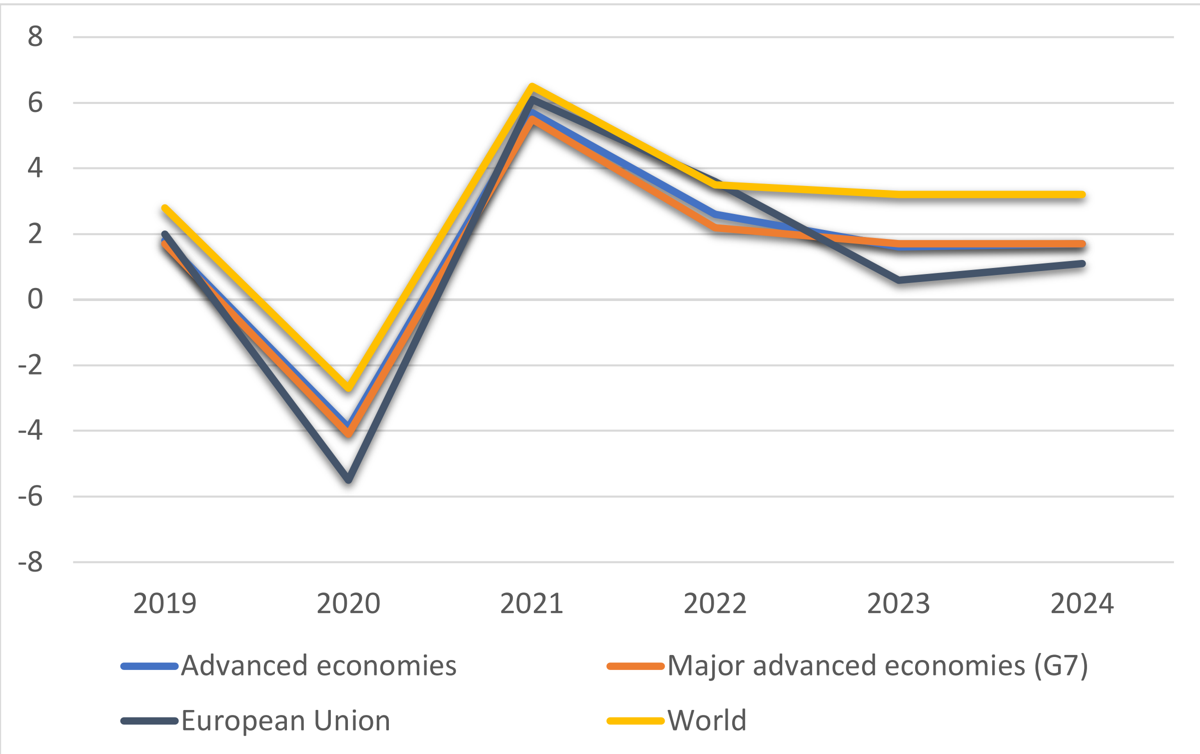
Labour market conditions played a crucial role in supporting economic activity and disinflation. The labour force expanded more than anticipated, bolstered by robust employment growth. This expansion helped sustain activity and contributed to disinflationary pressures in advanced and several large emerging markets and middle-income economies. Additionally, the influx of foreign-born workers in regions like North America and Europe supported labour force growth. Nominal wage growth in advanced economies has been contained since 2022, particularly in the euro area, leading to moderation in real wages. Despite these trends, wage-price spirals have generally not materialised, with wages at the lower end of the distribution rising faster than the average since the beginning of the pandemic. The resilience in global economic activity was compatible with falling inflation thanks to a post-pandemic expansion on the supply side. Greater-than-expected rises in the labour force amid robust employment growth supported activity and disinflation in advanced economies and several large emerging market and middle-income economies (IMF, 2024a). Core inflation has also seen a decline, driven by the dissipation of pass-through effects from previous price shocks, notably in energy (Dao et al., 2023). The easing of labour market pressures and a reduction in near-term inflation expectations have further supported this trend. However, financial-market-based inflation expectations in the US have shown signs of picking up recently (Auclert et al., 2023).

Monetary policy remains restrictive but is set to ease as inflation continues to fall. The increase in policy interest rates has led to higher mortgage costs and tighter credit availability, impacting business and residential investment. The commercial real estate sector, particularly office markets, has faced significant pressure due to higher borrowing costs and the shift towards remote work. Despite concerns, a global economic downturn caused by a sharp rise in policy rates has not materialized. This is partly because central banks, including the European Central Bank and the Federal Reserve, raised their nominal interest rates after inflation expectations started to rise, resulting in lower real rates that initially supported economic activity. Additionally, households in major advanced economies were able to draw on substantial savings accumulated during the pandemic, limiting the impact of higher borrowing costs on their spending. Changes in mortgage and housing markets over the pre-pandemic decade of low interest rates also limited the drag of the recent rise in policy rates on household consumption in several economies (IMF, 2024a).

Advanced Economies: A Closer Look

Advanced economies exhibited unique trends in the context of global disinflation. The US, for example, saw significant fiscal expansion, which bolstered private consumption despite rising interest rates. The labour market remained tight, with unemployment rates low and nominal wage growth contained. This environment contributed to a steady decline in inflation rates. By the last quarter of 2023, the headline inflation in the US had fallen to 2.3% on a quarter-over-quarter annualised basis. In the euro area, the recovery from inflationary pressures has been slower, partly due to weak consumer sentiment and the lingering effects of high energy prices. Nevertheless, inflation rates have trended downward, with fiscal policies becoming slightly more expansionary than expected. The Euro area saw a fiscal stance increase of 0.2% of GDP, contributing to aggregate demand. Japan, meanwhile, maintained near-zero policy rates, resulting in steady economic activity but slower progress in disinflation compared to other advanced economies. The unique economic structure and persistent deflationary tendencies in Japan have shaped its current economic landscape.

Figure 4.3 Real GDP growth trend (Annual percent change)



Elaboration on IMF 2024 data.

Overall, advanced economies are expected to experience a gradual recovery in real incomes as inflationary pressures subside. The projected growth for advanced economies is set to rise slightly from 1.6% in 2023 to 1.7% in 2024 and 1.8% in 2025 (see Figure 4.3). The US is expected to see a growth increase to 2.7% in 2024, driven by sustained private consumption and fiscal support, before moderating to 1.9% in 2025 as fiscal tightening measures take effect (IMF, 2024a).

Global Trade and Supply Chain Pressures

World trade growth is projected to be 3.0% in 2024 and 3.3% in 2025, remaining below the historical annual average growth rate of 4.9% from 2000 to 2019. This slower growth in trade reflects the relatively low economic growth outlook and is expected to result in a stable ratio of world trade to GDP over the medium term. Even as world trade-to-GDP ratios remain relatively stable, significant shifts in trade patterns are taking place, with increasing fractures along geopolitical lines, especially since the start of the war in Ukraine in February 2022. Growth in trade flows between geopolitical blocs has declined significantly since then compared with growth of trade within blocks. This reallocation of trade flows is occurring in the context of rising cross-border trade restrictions and increased concerns about supply-chain resilience and national security (Global Trade Alert, 2023).

Commodity markets experienced volatility due to geopolitical tensions, climate events, and the post-pandemic recovery. Prices for key commodities, including metals and agricultural products, fluctuated significantly. Between August 2023 and February 2024, the IMF's base metals price index rose by 4.7%, with iron ore prices increasing by 14.9% due to record steel production in China. Agricultural commodity prices also rebounded, with the IMF's food and beverages price index gaining 6.0%. However, the effects of El Niño led to significant price increases for tropical crops like cocoa and coffee (IMF, 2024a).

Supply chain pressures, which had eased significantly since the pandemic, were exacerbated by geopolitical tensions and environmental factors. Attacks on commercial shipping in the Red Sea and climate extremes in the Panama Canal led to increased global transportation costs. Despite these disruptions, global supply chain pressures remained below their 2021–2022 levels. The resolution of pandemic-era supply chain problems allowed delivery times to decline and transportation costs to decrease. After attacks on commercial shipping in the Red Sea—through which 11 percent of global trade flows—global transportation costs increased, reflecting the rerouting of cargo from the Suez Canal to the Cape of Good Hope and continued trade disruptions from climate extremes in the Panama Canal, but remained well below their 2021-22 levels and have recently declined (Federal Reserve Bank of New York, 2023).

Fiscal Consolidation and Debt Sustainability

The IMF (2024a, 2024b) remarks that a renewed focus on fiscal consolidation is crucial for rebuilding budgetary room to handle future shocks and curbing the rise of public debt. Major central banks are expected to ease monetary policy, and economies are better positioned to absorb the economic effects of fiscal tightening. The size of the fiscal adjustment needed to ensure government debt sustainability is significant. Ensuring that any new tax cuts or spending increases are funded and do not expand budget deficits is necessary to preserve the envisaged fiscal adjustment path. Advanced economies, in particular, need to balance the pace of fiscal adjustment to avoid setting off a negative cycle of slowing activity and rising debt ratios. Supply-enhancing structural reforms and protecting targeted support for the most vulnerable, as well as priority investments during the adjustment, can mitigate the impact on economic activity and support debt reduction efforts over the medium term. The size of the fiscal adjustment needed to ensure government debt sustainability is large in numerous cases. A renewed focus on fiscal consolidation is crucial for rebuilding room for budgetary manoeuvre and priority investments and to ensure debt sustainability.

Delivering a smooth landing involves calibrating the pace of fiscal adjustment to avoid setting off a negative cycle of slowing activity and rising debt ratios. A gradual and sustained fiscal adjustment, rather than an abrupt one, is warranted to avert the risk of sharp expenditure cutbacks or tax increases that could undermine economic activity and political support for fiscal reforms. Rebuilding fiscal arsenals is necessary to manage the fiscal demands posed by future crises, such as climate change and demographic shifts, and ensure that fiscal policy remains supportive of inclusive growth. As central banks ease monetary policy, fiscal authorities must ensure that fiscal policies do not work at cross purposes, exacerbating demand pressures and stoking inflation.

July 2024 Update

In its July update, the IMF (2024c) projects global growth to remain steady at 3.2% for 2024 and 3.3% for 2025, consistent with the April 2024 forecasts. Despite this stability, the IMF highlights significant disparities in economic momentum across regions, ongoing inflationary pressures, and substantial policy uncertainties that complicate economic management.

At the start of the year, global economic activity and trade displayed resilience, particularly bolstered by robust technology exports from Asia. However, the US and Japan experienced notable slowdowns. The US economy, after a period of strong performance, faced a sharper-than-expected deceleration due to reduced consumption and negative net trade contributions. Japan's slowdown resulted from temporary supply disruptions linked to a major automobile plant shutdown in the first quarter. In contrast, Europe saw economic recovery, led by improvements in services activity. China's economy benefitted from a resurgence in domestic consumption and a temporary boost in exports, narrowing output divergences as cyclical factors waned. Inflation remains a persistent concern, especially in the services sector, which complicates monetary policy normalization. The persistence of higher-than-average services price inflation is partially offset by stronger disinflation in goods prices. In the US, a sequential rise in inflation during the first quarter delayed policy normalisation, putting other advanced economies, such as the Euro area and Canada, ahead in the easing cycle due to better-aligned inflation trends. Updated projections include upward revisions to commodity prices, with nonfuel prices expected to rise by 5% in 2024. Energy prices are forecast to decline by about 4.6%, influenced by OPEC+ production cuts and ongoing Middle East tensions (IMF, 2024c).

For advanced economies, the growth outlook reveals diverse prospects. The US growth forecast for 2024 is revised down to 2.6%, reflecting a slower-than-expected start to the year. Growth is projected to further slow to 1.9% in 2025 as the labour market cools and consumption moderates, with fiscal policy gradually tightening. By the end of 2025, US growth is expected to taper to its potential, closing the positive output gap. In the euro area, economic activity appears to have bottomed out, with a modest growth of 0.9% projected for 2024, an upward revision driven by stronger momentum in services and higher-than-expected net exports. Growth is expected to rise to 1.5% in 2025, supported by increasing consumption due to rising real wages and higher investment from easing financing conditions amid gradual monetary policy loosening. However, persistent weaknesses in manufacturing suggest a slower recovery in countries like Germany. France's growth outlook is revised upwards slightly, while Italy and Spain also show improved projections due to stronger-than-expected economic activity. Japan's growth forecast is revised downward to 0.7% for 2024 due to temporary supply disruptions and weak private investment. However, a turnaround is expected in the second half of the year, supported by strong wage settlements. The United Kingdom shows modest growth prospects with a projected 0.7% growth in 2024, reflecting improvements from a low base and gradual recovery in economic activity. Canada is expected to see growth of 1.3% in 2024, with the forecast reflecting stable economic conditions and supportive fiscal policies (IMF, 2024c).

The IMF (2024c) emphasises the need for policymakers to focus on restoring price stability and addressing the legacies of recent crises, including replenishing lost buffers and enhancing growth prospects. Central banks are advised against premature easing and should remain prepared for further tightening if necessary. Fiscal consolidation should be prioritised, supported by robust fiscal frameworks and effective resource mobilization. To revitalise medium-term growth prospects, policymakers must address productivity trends and enhance business dynamism. Integrating women and immigrants into the labour force can mitigate demographic pressures and boost potential growth. The IMF also stresses the importance of multilateral cooperation and trade in addressing global challenges like climate change. Countries are urged to reduce trade-distorting measures and strengthen the multilateral trading system to foster global economic stability and growth.

4.3 Analysis of the Economic Factors relevant to Defence Spending

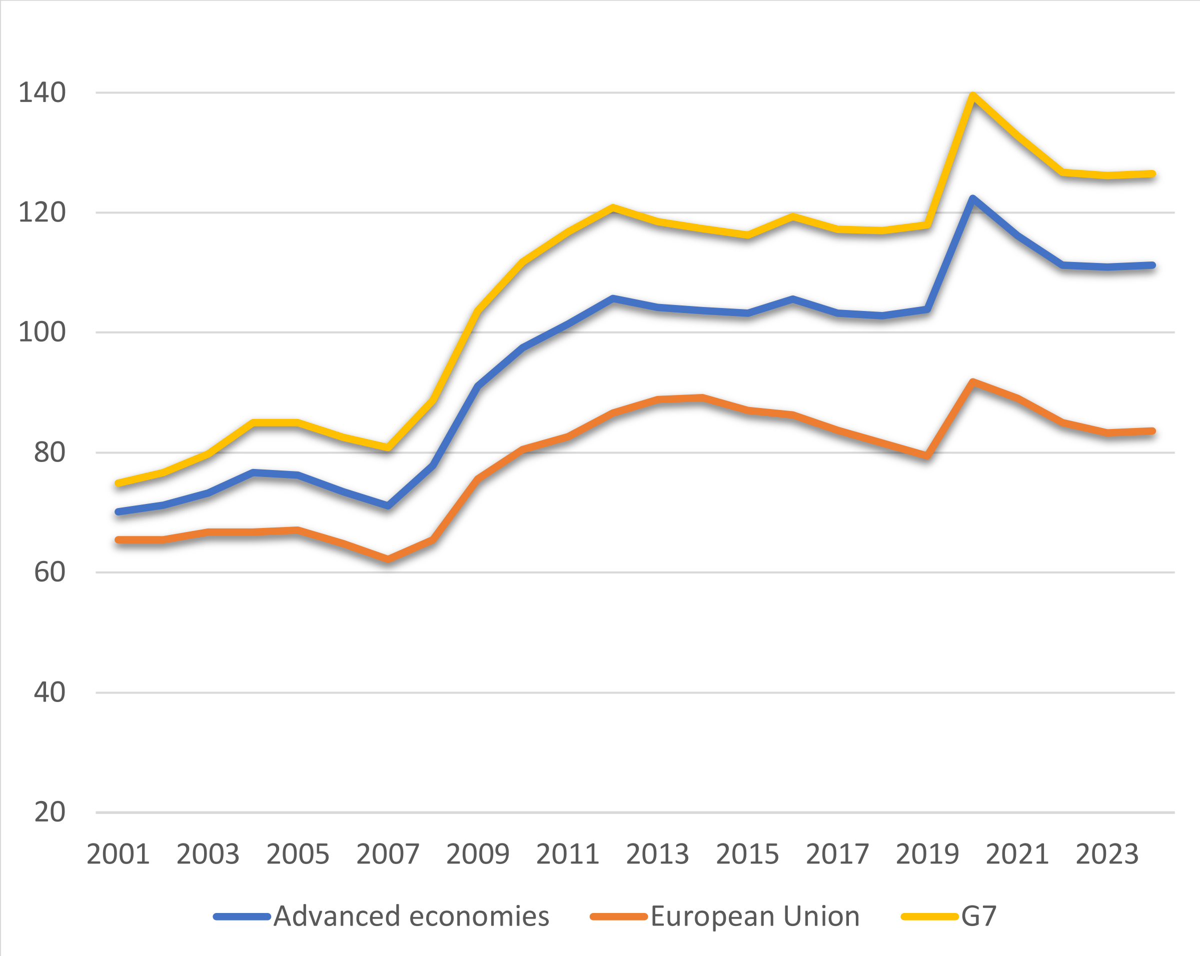
The current geopolitical environment, characterised by evolving security threats and the need for greater military readiness, necessitates increased defence spending among NATO members. Therefore, it is essential to examine and comprehend the state of public finances across these countries. A thorough analysis is useful to reveal potential fiscal constraints and challenges that could impact their capacity to meet heightened defence requirements.

As seen in the previous section, the recent inflation slowdown and improved financing conditions have avoided huge disruptions in the world's economy, but the debts, deficits, and fiscal risks are still a concern. According to the IMF (2024b), in 2023, monetary policy remained tight in over 85% of the world's economies, while fiscal policy tightening fell back to half from around 70% in 2022. The unexpected boosts to government revenues from high inflation have waned, while spending remains very high due to the still present pandemic-related support measures and new government support programs. The progress towards fiscal normalisation to pre-pandemic levels stalled. The background to this includes high public debt, slow medium-term growth, and interest rates that are still high. On a global level, public debt has slightly increased in 2023, remaining about 9 percent of GDP above pre-pandemic levels after its significant decline in 2021–22. Revenues in advanced and emerging economies increased by 1.4 percentage points of GDP more than pre-pandemic forecasts. Similarly, primary spending remains high, largely surpassing pre-pandemic projections. In advanced economies, the high spending is partly influenced by the lingering subsidies for crisis programs related to pandemics and new policy support measures. Public finance risks remain high and are expected to retighten in 2024 (IMF, 2024b). Furthermore, the numerous elections planned for 2024 involve acute fiscal risks, quite often leading to fiscal slippage—this time compounded by increased demands for social spending (Ebeke and Ölçer, 2017; Fatás and Mihov, 2013). Another source of pressure on public finances may come from geopolitical conflicts and natural disasters, which are forcing further fiscal support.

Global Overview

According to the IMF (2024b) medium-term projections, there will be a continuous rise in global public debt, particularly in the US, where it is projected to soar to historical highs. Other economies are forecast to gradually stabilise their respective debt-to-GDP ratios at higher levels than what was forecasted before the pandemic (see Figure 4.4). The high level of public gross financing needs makes fiscal policy rather sensitive to changing financing conditions. Furthermore, climate and demographic challenges, along with new industrial and defence spending mandates, will put additional pressure on public finances. In other words, many countries require larger fiscal adjustments than currently projected to ensure fiscal sustainability while still protecting vulnerable populations. Fiscal adjustments are necessary in order to avoid the financial repercussions that a reduced fiscal space in the event of future crises could entail. An immediate phasing out of the pandemic-related fiscal policies is therefore required, along with reforms to manage the rising spending. Increases in spending must be matched by corresponding growth in revenues. In addition, fiscal policy should help spur innovation, supporting higher productivity growth through technological adoption. Targeted fiscal incentives across firms and the innovation lifecycle are needed to minimise costs and prevent resource misallocation.

Figure 4.4 General government gross debt trend (% of GDP)

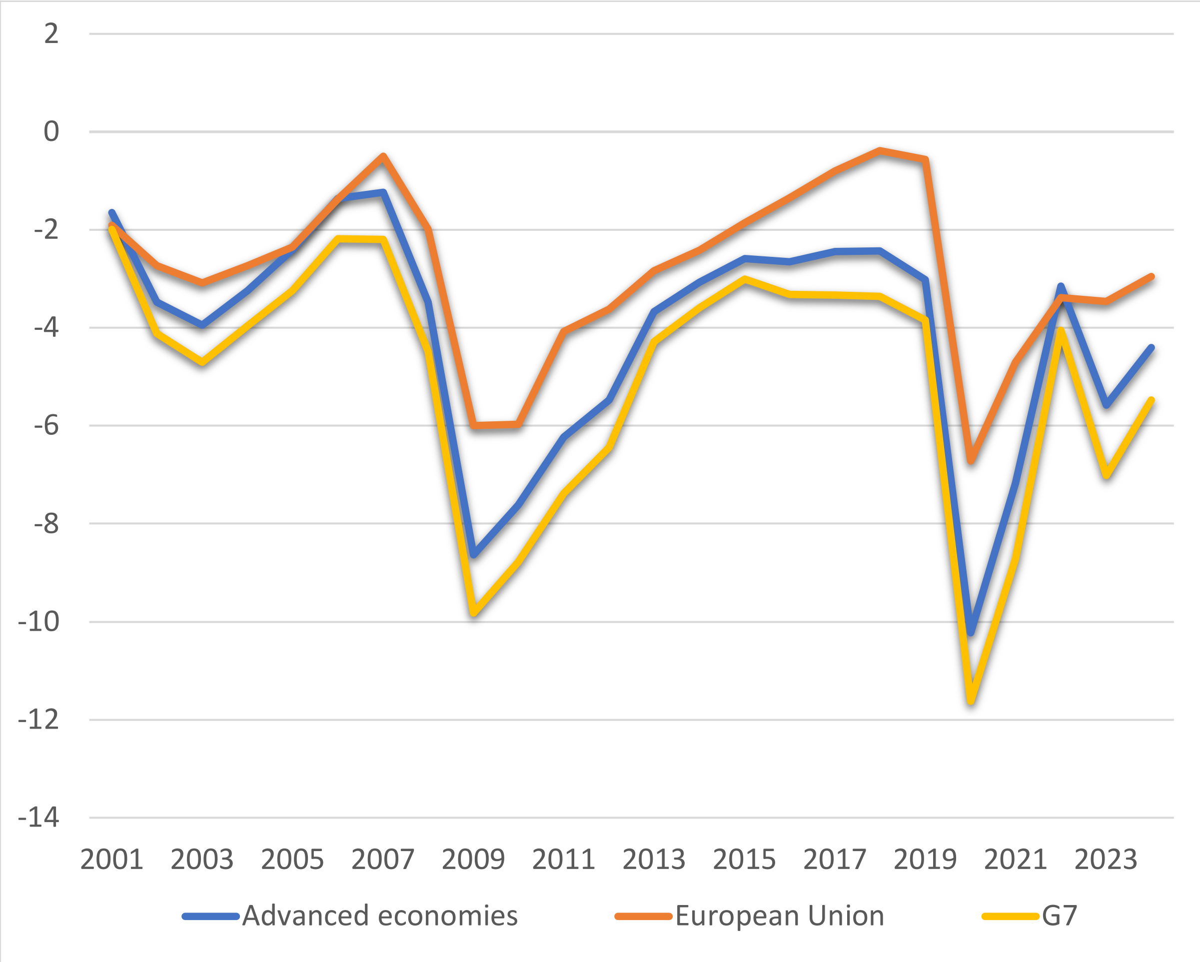


Elaboration on IMF 2024 data.

Compared with the improvements recorded in 2021–22, world fiscal deficits climbed an average of 1.6 percentage points to 5.5 percent of GDP in 2023, with global public debt up some 2 percentage points to 93.2 percent of GDP. The main reason for the larger fiscal deficits was a reduction in revenues, as windfall revenues coming from the surge in inflation decreased, but expenditures were little different from those in 2022. Oil producers and commodity exporters had much lower fiscal surpluses of about 0.5 percent of GDP, due to the sharp fall in revenues by about 3 percentage points of GDP on average, which went hand in hand with the decline in global commodity prices from their levels in 2022. Indeed, fiscal tightening is expected to resume gradually in 2024, reducing the deficit at the aggregate level to an estimated 4.9 percent of GDP (see Figure 4.5). Over the medium term, fiscal consolidation is likely to be moderate; the overall deficit is projected to stabilise at 4.3 percent of GDP by 2029, about 0.7 percentage points higher than in 2019. This would support debt stabilisation in a large number of economies over the medium term. Net debt, however, is expected to surge to almost 100 percent of GDP by the year 2029. A few large economies—especially China, Italy, the United

Kingdom, and the US—will drive this and really need critical policy actions on the basis of addressing the core imbalances between spending and revenues (IMF, 2024b).

Figure 4.5 General government overall balance trend (% of GDP)

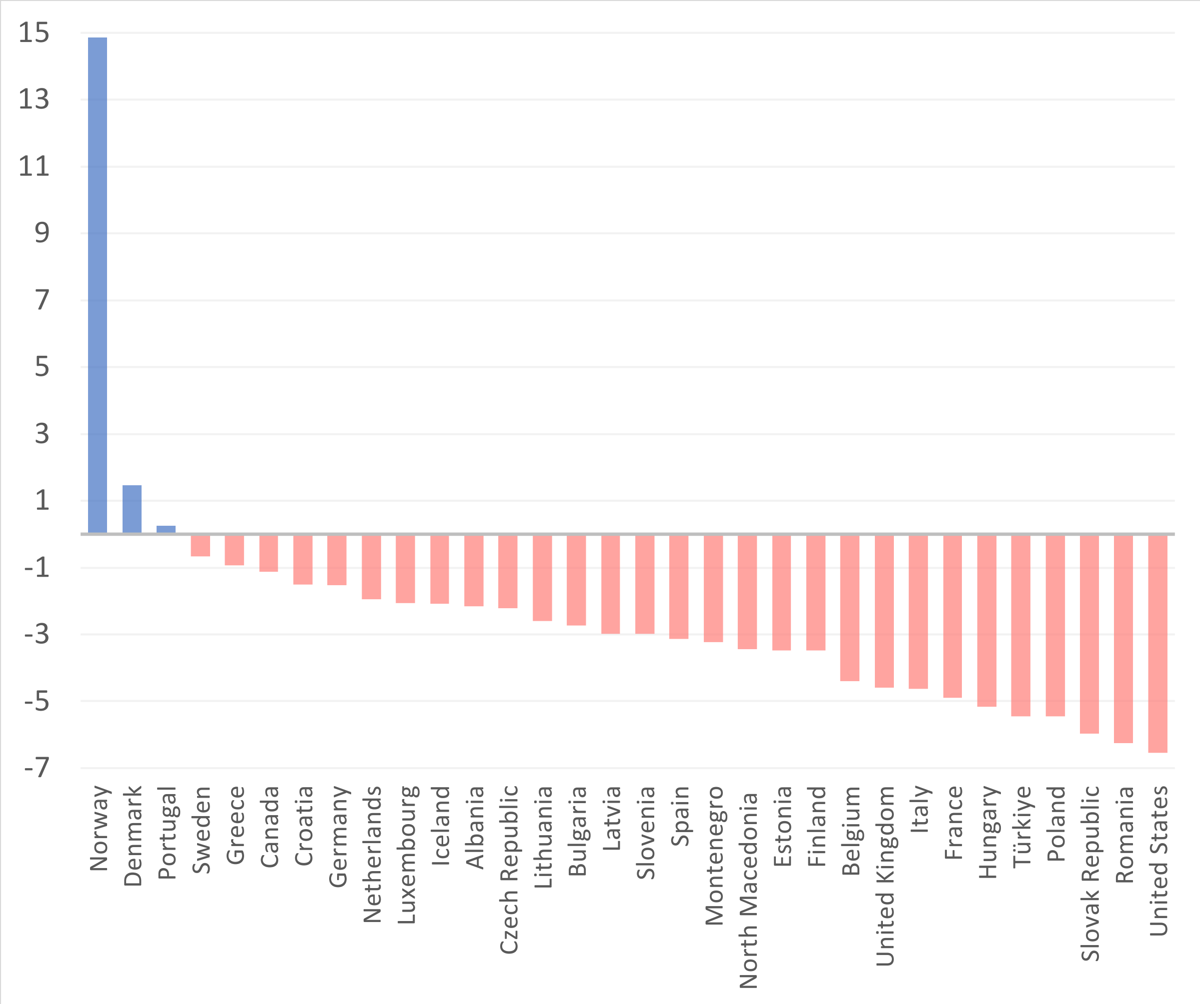


Elaboration on IMF 2024 data.

NATO Countries

NATO countries faced rising primary deficits in 2023, driven by a combination of policy inertia and new fiscal pressures. Despite a significant drop in energy prices, many governments opted to retain subsidies and transfers initially introduced to buffer against energy price shocks rather than rolling them back. Concurrently, pandemic-related support programs, such as Italy's Superbonus, were prolonged, further straining public finances. In addition, new fiscal stimulus packages introduced across several NATO members incorporated costly changes to taxation policies, social security contribution cuts, and spending initiatives. These packages often rested on overly optimistic financing assumptions, contributing to a widening fiscal gap. In 2024, a shift toward fiscal consolidation is anticipated, with the average overall balance projected to reach -2.5% of GDP, signalling a modest reduction in deficits (see Figure 4.6). This improvement will likely stem from the gradual phasing out of energy subsidies and other pandemic-related support measures. Over the medium term, further fiscal adjustments are expected, with the average primary deficit forecasted to decline by 2029. This reflects a concerted effort to stabilise fiscal policy and manage public debt more sustainably (IMF, 2024b).

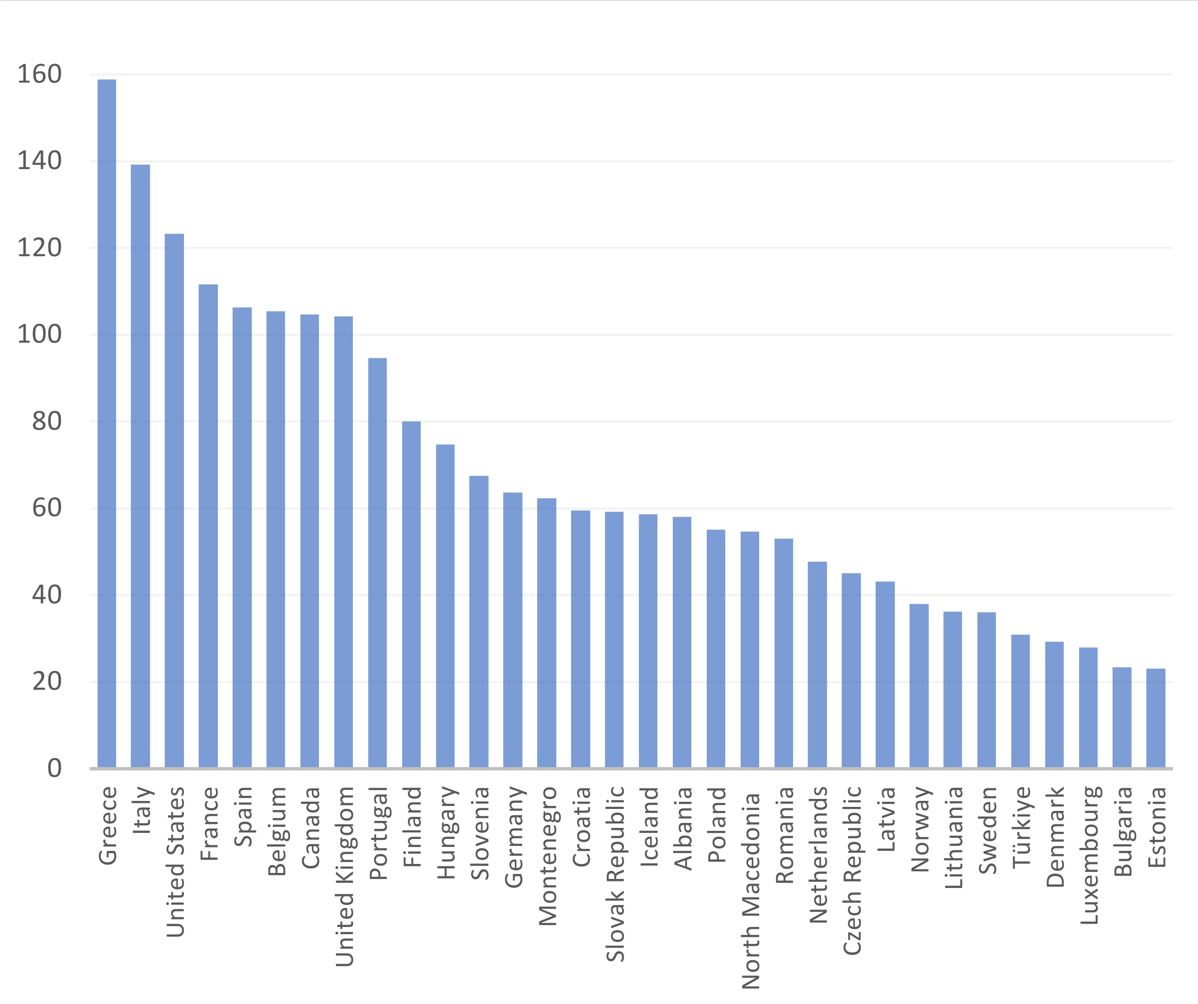
Figure 4.6 Overall balance (% of GDP) for NATO countries in 2024



Elaboration on IMF 2024 data.

Public debt levels across NATO countries are expected to average 68.0% of GDP in 2024 (see Figure 4.7). Although some downward adjustment is projected, structural challenges—such as demographic shifts and labour market mismatches—could push debt trajectories upward over time. In countries like Belgium and Finland, for example, these pressures could add between 7 and 10 percentage points of GDP to government debt within the next five years, underscoring the need for sound fiscal management. Expenditure remains high across NATO, with an average of 44.7% of GDP in 2024, highlighting the substantial role of government spending in these economies. Despite efforts to consolidate, the persistence of high expenditures and delayed fiscal reforms will likely complicate debt management efforts. Demographic trends, such as ageing populations, combined with labour market inefficiencies, will further strain fiscal balances in the coming years. These economic and fiscal dynamics suggest that while NATO countries are beginning to take steps toward fiscal consolidation, significant challenges remain. Policymakers will need to navigate shifting economic conditions carefully, balancing the need for fiscal responsibility with ongoing social and economic demands. Without a careful and sustained policy adjustment, public finances may remain under pressure, with potential long-term implications for debt sustainability and economic stability (IMF, 2024b).

Figure 4.7 General government gross debt (% of GDP) for NATO countries in 2024



Elaboration on IMF 2024 data.

European Union

In February 2024, an agreement was reached between the Council of the European Union and the European Parliament on a new economic governance framework for the EU's member states (European Commission, 2024). It will aim to address, through a common approach, the fiscal challenges faced by each member through the setting of medium-term country-specific adjustment paths. These adjustments will focus on net primary expenditures other than interest payments, cyclically adjusted unemployment benefits, and expenditures on EU programs. Normally, the space provided for implementing the base adjustment is four years. However, countries that commit to reforms that have implications for resilience to shocks or growth or for fiscal sustainability can extend the country window to seven years to avoid sharp annual fiscal adjustments. This framework aims to re-establish and ensure fiscal sustainability along two dimensions: public debt has to be put on a credible downward path or maintained at prudent levels if it already is so. This is checked with the help of a debt sustainability analysis according to the methodology defined by the European Commission. The corrective measures shall ensure an averting debt path for ten subsequent years after the correction period. High fiscal deficits shall be reduced below 3 percent of GDP by the end of the correction period and shall stay below this value for the next ten years. It has two minimum adjustment safeguards: a debt sustainability safeguard and a deficit resilience safeguard. Countries where the debt-to-GDP ratio is above 90 percent are expected to show a reduction of 1 percentage point of GDP per year over the adjustment period. For those countries where it stays in the range of 60 percent to 90 percent, a reduction of 0.5 percentage points per year is required. Moreover, the structural primary balance should be improved, on an annual basis, by at least 0.4 percent points of potential GDP in countries with a four-year adjustment period and by at least 0.25 percent points in countries with a seven-year period until the structural balance is above -1.5% of potential GDP. Member states that violate the fiscal requirements—those that have a deficit of more than 3 percent of GDP or diverge from the agreed net expenditure path—will be liable to an Excessive Deficit Procedure (EDP). Under this procedure, a country is required to make a minimum annual adjustment of 0.5 percent of GDP to ensure that the deficit comes back down to become compliant. If a member state is in the EDP, current primary balances are exempt from the annual requirement under the debt-reduction rule safeguard. The new framework of multiyear nominal expenditure paths represents an advance over earlier work in providing a way to monitor compliance. Governments are called upon to come up with realistic medium-term plans but are supported to be in a position to implement reforms that will enable economic growth and sustainability. In realising this, however, such adjustment paths can only work through political commitment. The framework also mandates governments to set up solid frameworks for medium-term budgeting and achieve proper resource-filled, independent national fiscal councils that oversee and ensure fiscal plans and forecast fairness (Arnold et al., 2022).

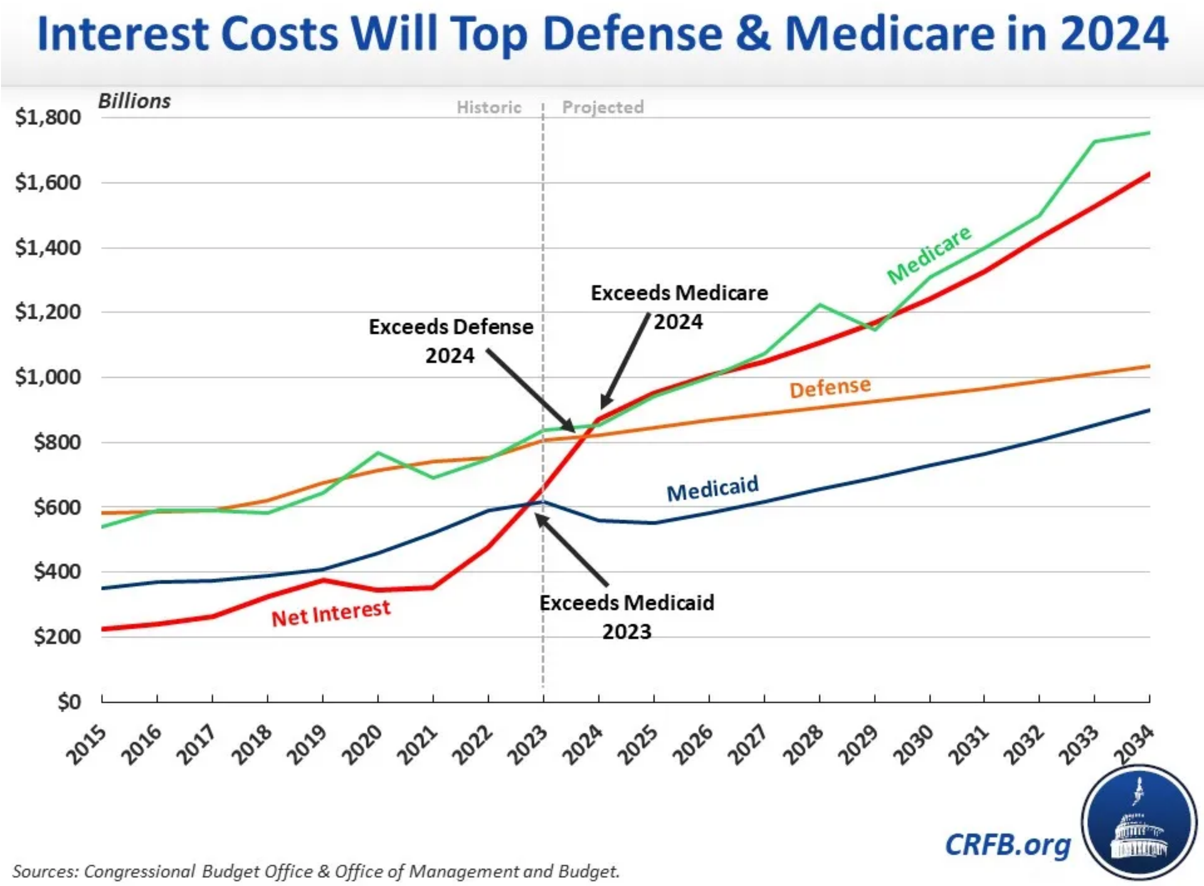
United States

The evolution of fiscal trends in the US is expected to be a key driver and ongoing source of upward pressure on global fiscal projections. At present, the country's policy setting would almost double the public debt by 2053, which would have a huge impact on the world economy and pose very substantial risks to fiscal projections in other countries. 2023 marked one of the major cases of fiscal slippage in the US, with its general government fiscal deficit increasing to 8.8 percent of GDP from 4.1 percent in the previous year on account of strong economic growth. The reasons are a steep fall in income tax revenues by 3.1 percentage points of GDP and an increase in government spending by 1.3 percentage points of GDP. On average, the overall fiscal deficit is expected to lie above 6 percent of GDP in the medium term (IMF, 2024b). According to empirical analysis (Bianchi and Melosi, 2022), the additional fiscal impulse in 2023 has added about 0.5 percentage points to core inflation. Uncertainty related to US fiscal policy and long-term rates may have an adverse effect on financial conditions globally. The loose US fiscal policy could complicate efforts to lower inflation and heighten the debt burden, while global interest-rate spillovers might add to financial conditions, with mounting risks elsewhere.

In 2024, the Congressional Budget Office (2024) estimates that interest payments on federal debt will reach a record of $892 billion. This would be more than the federal government's entire defence budget, a nearly one-third increase over 2023. The CBO pointed to the high level of interest rates and an expanding federal government debt as the reasons for the huge jump. The ballooning debt stems from spending at the federal level in the face of the Great Recession, the pandemic, and, as said above, a downturn in tax revenues. These changes added up to send the debt-to-GDP ratio to post-World War II highs. New projections show public federal debt reaching $28.2 trillion, an amount equal to 99% of GDP, at the end of 2024. The interest burden has become far heavier because, in response to pandemic-driven inflation, the Federal Reserve has jacked the benchmark Fed funds rate from near-zero in March 2022 to a range of 5.25–5.5% by July 2023. Borrowing costs skyrocketed, and the yield on 10-year Treasury notes hit 4.2% in June 2024, the highest in 15 years. While the Federal Reserve is probably going to gently bump the Fed funds rate higher as inflation cools, the CBO expects yields on 10-year Treasury notes to decline to just 3.6% in late 2026 and then gradually climb back to 4.1% by 2034. This double-whammy effect of high debt and rising interest rates also means that the costs of servicing the federal government's debt are reaching historic levels relative to national income. By 2024, interest payments are projected to amount to 3.1%. Historically, net interest outlays have never exceeded more than 3.2% of GDP since 1940. CBO's June 2024 outlook forecast that it would exceed this level each year between 2025 and 2034. About two-thirds of the increase that CBO projects in net interest costs during the period between 2024 and 2034 stems from the predictable increases in average interest rates, with the other third arising from the projected rise in the amount of debt. In 2024, interest payments are projected to account for about 13% of federal outlays, which would make them the third-largest category of expenditure in the country, before defence, Medicare, and the income security programs. This is a vast increase over 2017, when net interest payments were close to 7% of federal outlays, and approaches mid-1990s levels, when net interest payments peaked at over 15% of fiscal outlays. Lower levels of interest rates and debt serve to explain the reduction in debt payments realised since the mid-1990s. In this respect, 2009–2017 statistics demonstrate that the debt-to-GDP ratio has gone up, with net interest payments remaining at permanently less than 7% due to it being a low-interest environment. What has happened is that the estimates of the interest burden have become much, much worse over a four-year interval. From estimating interest costs as a likely 10% of federal expenditures in 2034, now these costs are regarded as likely to exceed 16% of total government outlays (Congressional Budget Office, 2024).

A higher cost of servicing the debt would mean the government has to budget more spending on interest at the expense of defence, social safety net programs, research, and many other indispensable functions, as shown in Figure 4.8. As interest payments consume an increasing portion of government expenditures, the US may need to reduce other budgetary allocations or increase taxes to avoid further deficit expansion and subsequent borrowing. Debt service costs and, therefore, fiscal impacts of higher levels of outstanding debt would depend on interest rates, of course. To date, high-debt situations have combined with low interest rates, but recent rate hikes changed the budget deficits significantly that might only be managed from the point of tax increases or spending reductions.

Figure 4.8 Public Expenditures Trends in the US (Committee for a Responsible Federal Budget, 2024)



4.4 Analysis of Defence Spending trends

Historical Defence Spending in Europe

Since 1990, European countries have considerably expanded their social welfare systems, surpassing the rate of overall economic growth. While government budgets and economies have, in price-adjusted terms, grown to about 1.9 times their 1990 size, social spending has surged to 2.4 times its original level. This disproportionate growth in social spending stems from continuous increases, both during economic downturns where it serves as a safety net and during periods of growth, where it facilitates wealth redistribution. As a result, social spending has become the largest expenditure category for European governments, with an average of half of their budgets dedicated to social welfare programs. This prioritisation of social spending over defence is evident in the inverse relationship between the size of a country's welfare state and its likelihood of meeting the NATO 2% target (Dorn et al., 2024). Notably, the Baltic states, known for their low public debt ratios and high defence spending, also have some of the lowest social expenditures in Europe. The substantial growth of social spending, while serving an important social purpose, may hinder governments' ability to effectively address critical challenges, including defence. This is because once resources are diverted from the defence budget to other areas during peacetime, it becomes politically challenging to reclaim these funds when the need for increased defence spending arises. Consequently, governments may struggle to strike a balance between maintaining a robust social safety net and ensuring adequate defence capabilities in a changing geopolitical landscape.

Europe's Post-Cold War 'Peace Dividend': A Legacy of Underinvestment in Defence

Following the Cold War, a prevailing sense of security pervaded most European nations, leading to a diminished perception of external threats. Consequently, these nations scaled down their military capabilities, inadvertently increasing their reliance on the United States for security. This dependence manifested in several ways. Firstly, the United States currently shoulders 70% of the total defence expenditure within NATO, a significant increase from 61% in 1990. Secondly, Europe leans heavily on the United States' nuclear arsenal for deterrence, as the French and British nuclear stockpiles pale in comparison, each holding less than 10% of the United States' capacity. Lastly, the disparity in military equipment is stark, with the United States boasting 1.8 times more fighter jets than all European NATO members combined (Dorn et al., 2024). This over-reliance on the United States for security created a scenario where European nations could exploit the benefits of collective defence without contributing their fair share. This situation was exacerbated by the United States' willingness and capability, as the global military superpower, to safeguard its European allies. This security umbrella provided by the United States inadvertently allowed European countries to capitalise on a 'peace dividend', which refers to the economic resources that were freed up due to the reduced need for defence spending after the Cold War. European nations diverted these resources to other policy areas, resulting in an accumulated peace dividend of 1.8 trillion euros compared to the NATO 2% target since 1991 (Dorn et al., 2024).

However, this dependence on the peace dividend came at a cost. Many European countries, despite experiencing chronic budget deficits, prioritised the expansion of their welfare states. This left them ill-prepared for the changing security landscape, as evidenced by their sluggish response to the 2014 pledge to meet the NATO 2% target and their delayed reaction to the Russia-Ukraine war. Although all NATO members committed to increasing their defence spending to at least 2% of their GDP in response to the escalating security concerns in their immediate vicinity, by 2023 only ten out of 25 European NATO states, primarily those bordering Russia, had fulfilled this pledge (NATO, 2024d). The changing geopolitical landscape, particularly the United States' strategic shift toward the Indo-Pacific region due to China's growing assertiveness, further underscores the need for Europe to reassess its defence strategy. The potential for a reduction or complete halt in US military aid to Ukraine, coupled with the possibility of Russia reconstituting its military might within a decade, adds another layer of complexity to the situation. The analysis emphasises the need for European governments to focus on strengthening defence spending, moving away from the peace dividend, and enhancing their defence capabilities to safeguard security in an increasingly unpredictable global landscape.

Global Overview of Defence Spending

According to SIPRI (2024), world military expenditure in 2023 reached the historic high of $2443 billion, which is 6.8% higher in real terms compared to the previous year—and, in fact, the highest military expenditure ever recorded by the Swedish Institute. This increase corresponds directly to the ever-increasing geopolitical tensions across the world, with the conflict between Ukraine and Russia being the prime example. The global military burden—military spending as a percentage of global GDP—also rose to 2.3%, underscoring the growing prioritisation of defence budgets worldwide.

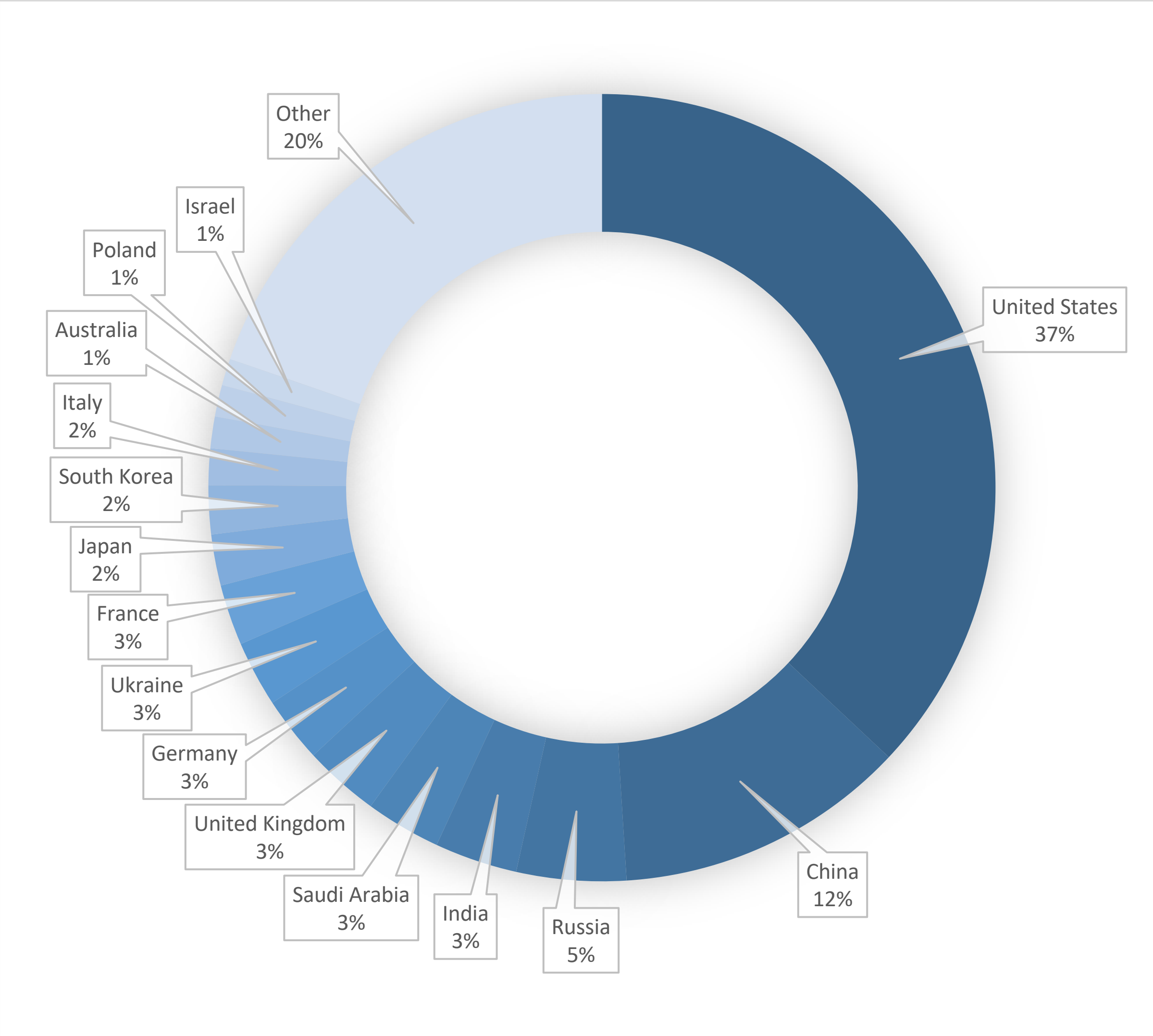
Military spending increased in 2023 in all five geographical regions—the Americas, Asia and Oceania, Europe, the Middle East, and Africa—for the first time since 2009. The most significant increase happened in Europe, where it increased by 13%. This was largely due to many European countries' responses to Russia's military aggression against Ukraine by significantly boosting their defence budgets. As a result of the heightened security concerns, many European countries reviewed their military readiness and capabilities, leading to an increase in spending in the defence sector. Military spending in Asia and Oceania also rose by 4.5%, partly as a result of the heightened strategic competition under way within the region, concerning the rapid growth in military capacity and assertiveness of China. Military expenditure increased by 1.1% in South Korea to approximately $47.4 billion. This increase is reported to reflect the response of the country to the continued threat from North Korea as it develops its missile and nuclear capabilities. South Korea has invested in modernising its military, enhancing its missile defences, and expanding its cyber capabilities. Japan's defence budget expanded by 11% to a total of $55 billion. This increase is part of Japan's grander strategy to reinforce its self-defence forces in the face of emerging security challenges from China and North Korea. Advanced fighter jets, missile defence systems, and naval capabilities will make up a larger share of Japan's increased spending, reflecting its strategic focus on securing its interests at sea and responding effectively to any threat that may emerge from the region. In the Middle East, Saudi Arabia remained the largest military spender, with its defence budget increasing by 4.3% to $75.8 billion in 2023. This expenditure shows strategic priorities for the kingdom in a bid to counter regional threats from Iran and to retain influence within the Gulf Cooperation Council and the wider Arab world. This means that Saudi Arabian defence spending is dominated by large-scale investments in advanced military hardware, from fighter jets to missile systems and naval capabilities. This has been fuelled by the need to advance its military deterrence and operational readiness. Saudi Arabia's continued involvement in the Yemen conflict and the protection of its borders and key infrastructure have also driven these expenditures by the kingdom. Other Gulf states, such as the UAE and Qatar, also reported high military spending, driven by their ambitions to maintain strong defensive postures in an unpredictable region. The UAE has tried to diversify its military acquisitions and invested in both Western and indigenous defence technologies in an effort to acquire advanced drones and cyber capabilities. On the other side, Qatar has also been increasing its defence budget due to the regional embargo and strained relations with neighbouring countries. It has developed state-of-the-art air defence systems and augmented its naval forces. Military expenditure in Africa was propelled by a mix of regional security challenges combined with internal conflicts. North African countries, particularly Algeria and Egypt, were significant contributors. Algeria focused on modernisation programs aimed at upgrading air and naval capabilities in response to regional instability and tensions, particularly in the Sahel. Meanwhile, Egypt continued to further build up its military capacity by acquiring state-of-the-art naval and air equipment amidst geopolitical interests in the Eastern Mediterranean and regional power projection. Compared with the global average, sub-Saharan African countries have generally kept lower defence budgets, but equally impressive increases have been recorded. Nigeria has increased defence spending to try and counter insurgencies, particularly from Boko Haram, while Kenya and Ethiopia have tried to pacify internal security challenges and regional conflicts (SIPRI, 2024).

Major Military Spenders

The top five military spenders in 2023 are the US, China, Russia, India, and Saudi Arabia, jointly accounting for 61% of global military expenditure (see Figure 4.9). The United States is the largest, with its military receiving $916 billion, accounting for 37% of world expenditure. This figure is up 2.3% from 2022 and continues the long-term rise in military budgets needed to maintain its global reach. A huge portion is taken up by research, development, testing, and evaluation, underscoring the US's quest for technological superiority in areas such as artificial intelligence, cybersecurity, and space capabilities. China, the second-biggest military spender, increased its military budget to an estimated $296 billion—a 6.0% rise from a year ago. That growth marked the 29th consecutive year of annual increases in military expenditure in China. The People's Republic of China's investments were associated with modernisation: renewal and reorganisation of its military forces, enhancement of naval capabilities, and structural funding for advanced technologies important in projecting power in the Asia-Pacific region and beyond. Russia's military expenditure rose by 24 percent to an estimated $109 billion, corresponding to 5.9% of its GDP. This major increase is largely driven by the conflict in

Ukraine, which has called for large amounts of spending on military operations. The actual extent of Russia's military spending may be understated because of the lack of transparency in financial reporting, especially for off-budget financing sources, including private sector contributions and funds from state-owned enterprises. India and Saudi Arabia were also placed among the top five military spenders. This put India's military expenditure at a 4.2% increase to $83.6 billion, as it sought to modernise and diversify military capabilities amid prolonged border tension with neighbouring China and Pakistan. An increase of 4.3 percent lifted Saudi Arabia's defence budget to about $75.8 billion, underscoring its continuing emphasis on military preparedness in a region riven by instability and conflict (SIPRI, 2024).

Figure 4.9 Share of World Military Expenditure

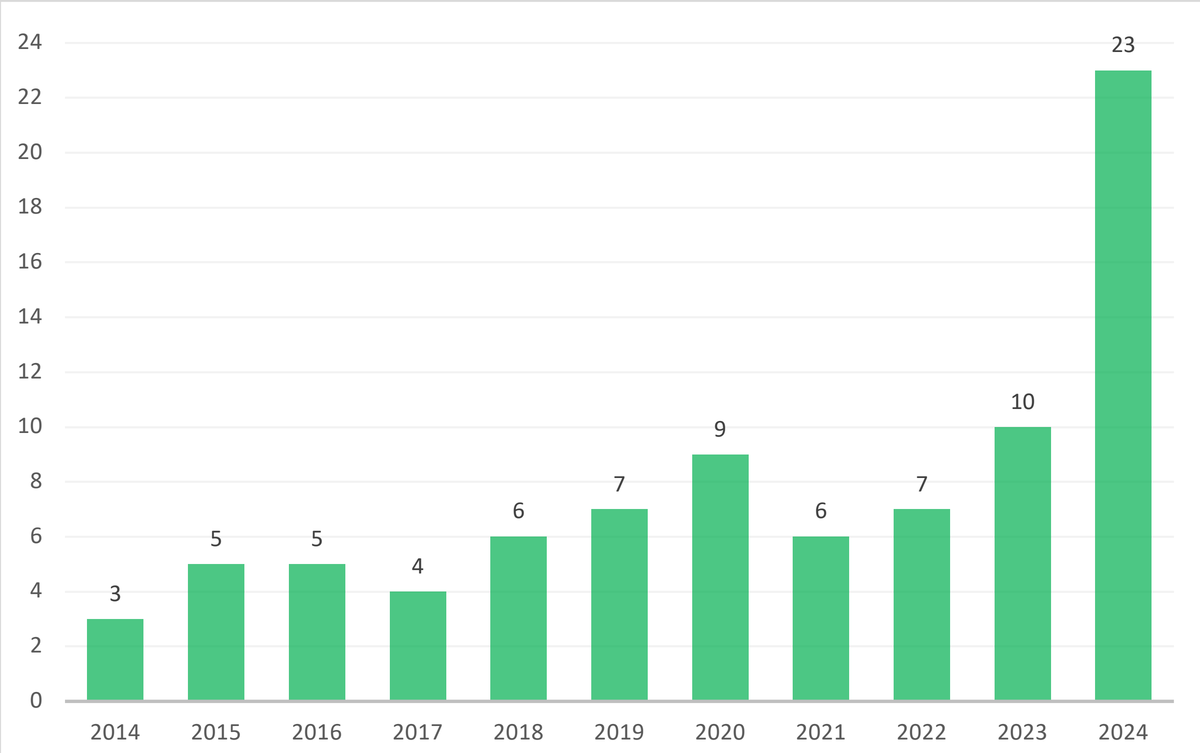


Elaboration on SIPRI 2024 data.

NATO Defence Spending Increases

In 2023, NATO member states collectively spent $1341 billion on defence, accounting for 55% of the global total. This significant allocation underscores the alliance's collective commitment to maintaining a robust defensive posture in response to various emerging threats, particularly the perceived security challenges posed by Russia. The increase in NATO's total military expenditure marks a concerted effort among member states to enhance their military capabilities and readiness, aligning with the Alliance's strategic objectives of ensuring collective security and deterrence. A notable development within NATO is the growing number of member countries meeting the alliance's guideline of spending at least 2% of their GDP on defence. In 2023, this number rose to 10 member states, reflecting a significant increase from previous years. This growth is particularly evident among Eastern European nations, which have been most directly affected by the security implications of the Russian invasion of Ukraine. For instance, Poland's military spending surged by an impressive 75%, driven by heightened security concerns and a commitment to strengthening its defence forces. Poland's substantial increase in defence budget has been channelled into expanding its armed forces, acquiring advanced military equipment, and enhancing its logistical and operational capabilities. In 2024, the number of NATO member countries meeting the Alliance's guideline of spending at least 2% of their GDP on defence rose to 23 (NATO, 2024d), a notable increase as shown in Figure 4.10.

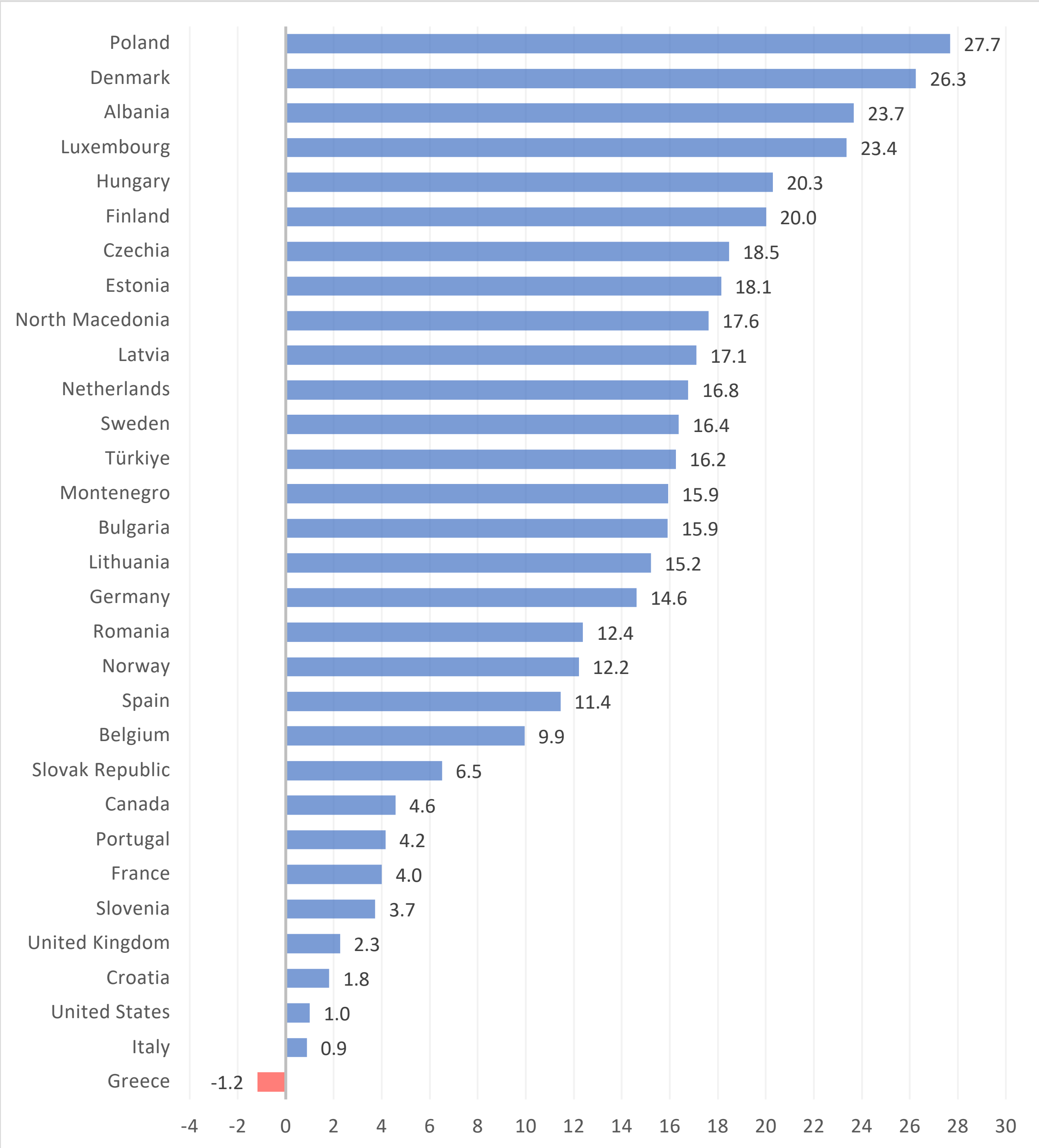
Figure 4.10 Number of NATO Allies meeting the 2% of GDP target



Elaboration on NATO 2024 data.

Other Eastern European countries, such as the Baltic States (Estonia, Latvia, and Lithuania), have also significantly increased their defence spending. These nations, situated on NATO's eastern flank, have prioritised bolstering their military capabilities as a deterrent against potential aggression, particularly given their historical experiences and geographical proximity to Russia. This increased spending includes investments in cyberdefence, advanced missile systems, and modernising infantry and mechanised units, aimed at enhancing both conventional and unconventional defence capabilities. Furthermore, Western European NATO members have also shown renewed commitment to defence spending. Germany, for instance, has announced plans to significantly boost its defence budget, reversing a trend of relatively low military expenditure. This change is part of a broader initiative to modernise the Bundeswehr, Germany's armed forces, and to fulfil its NATO obligations. The United Kingdom and France, both nuclear-armed states, continue to invest heavily in maintaining and modernising their nuclear deterrents, as well as expanding capabilities in areas such as cyber warfare and space defence. In the years following the invasion of Ukraine, NATO allies have increased defence spending by an average of 13% annually, as shown in Figure 4.11 (NATO, 2024d).

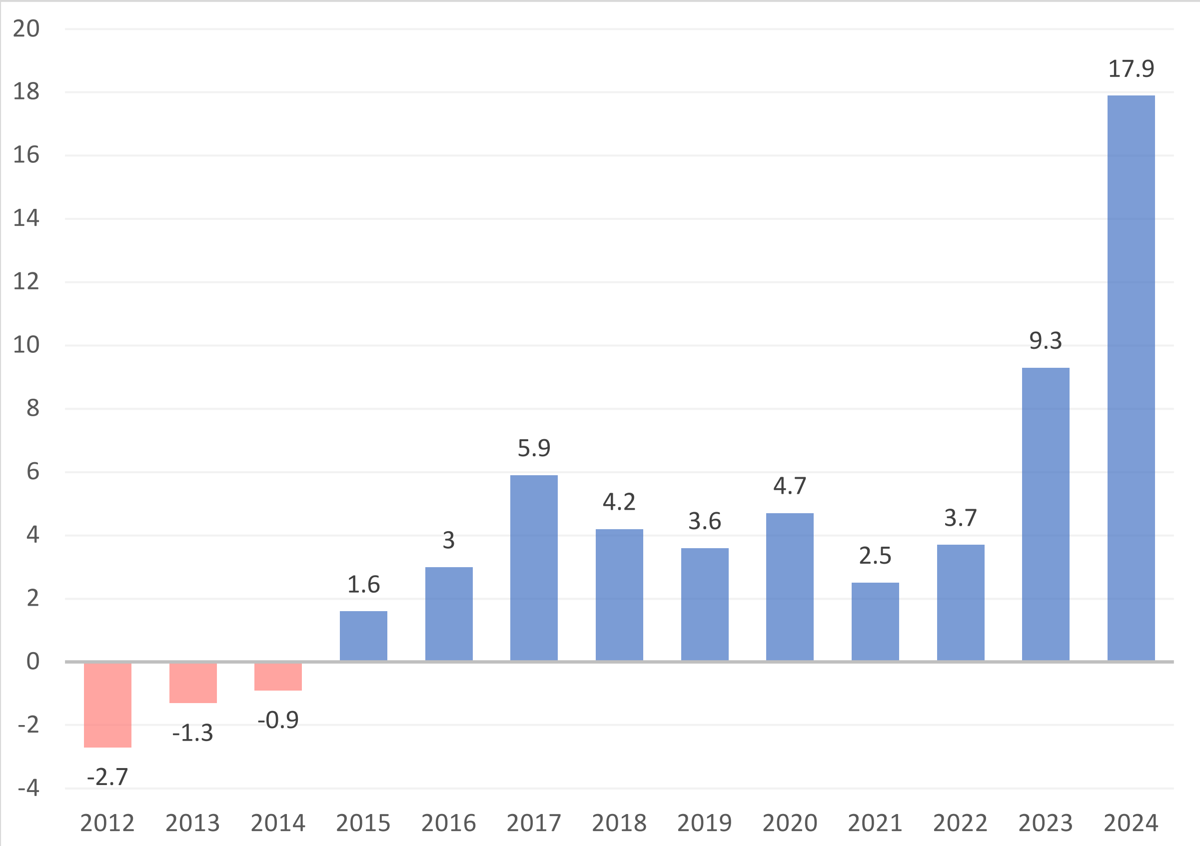
Figure 4.11 Defence expenditure annual real change (%) Average 2022-2024



Elaboration on NATO 2024 data.

All these findings confirm the trend of rising military expenditures by European members of the alliance, aimed at increasing their military independence from the US (see Figure 4.12).

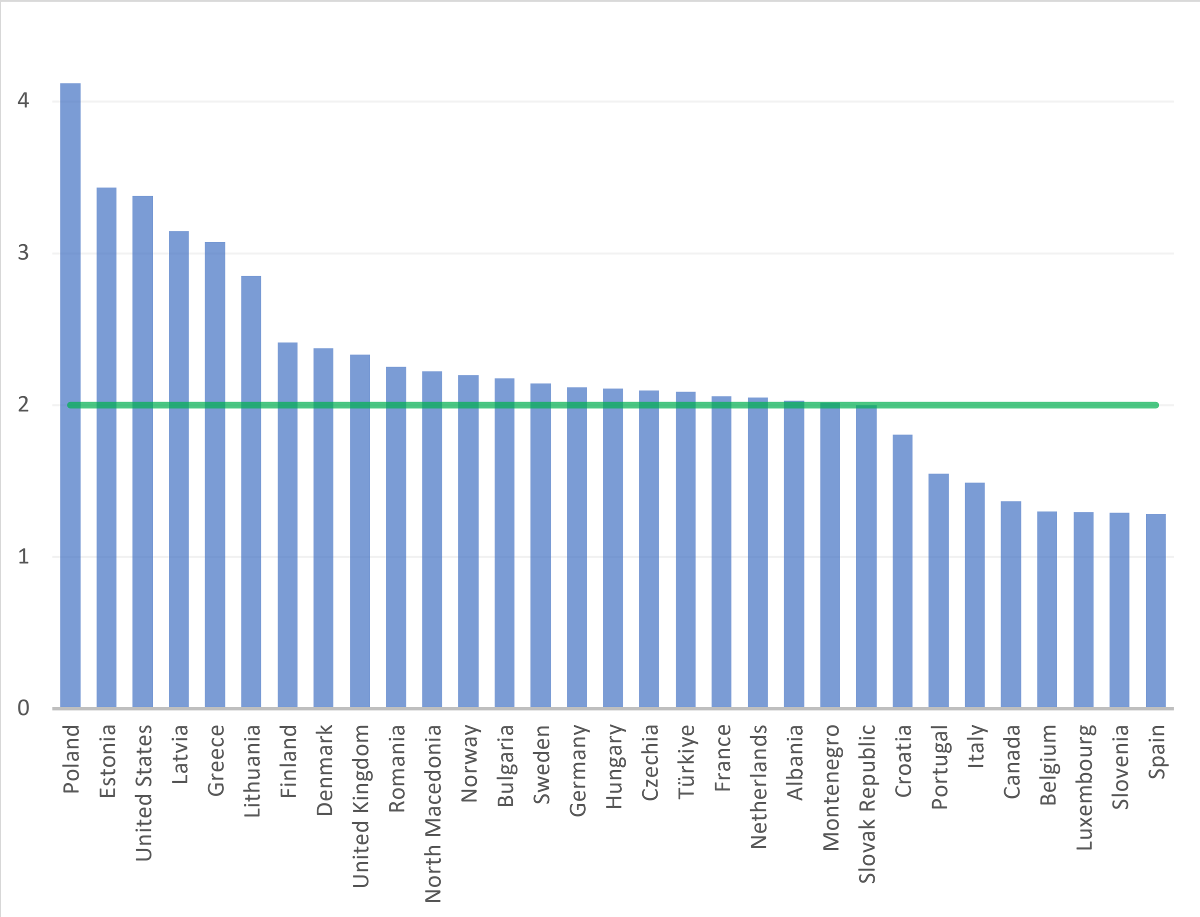
Figure 4.12 NATO Defence Expenditure by European members and Canada (Annual real change, based on 2015 prices and exchange rates)



Elaboration on NATO 2024 data.

NATO's increased defence spending also reflects a broader strategic recalibration within the alliance, focusing not only on traditional military threats but also on emerging domains such as cyber and space. The alliance has emphasised the need for enhanced resilience against hybrid threats, including cyberattacks, disinformation campaigns, and other forms of non-conventional warfare. This strategic shift is accompanied by increased investments in cyber defence infrastructure, intelligence capabilities, and the development of rapid response forces capable of countering a wide range of threats. As reported above, NATO European allies are stepping up to the new challenging geopolitical environment. However, some countries are still below the agreed-upon defence spending threshold (see Figure 4.13). These countries are Belgium, Canada, Croatia, Italy, Luxembourg, Portugal, Slovenia, and Spain. In addition, as shown in the data below, these countries, with the exception of Luxembourg, are also in the bottom positions for increases in military spending, measured in real terms, since the Ukraine invasion (NATO, 2024d).

Figure 4.13 Defence expenditure of NATO allies as a share of GDP in 2024 (Based on 2015 prices)



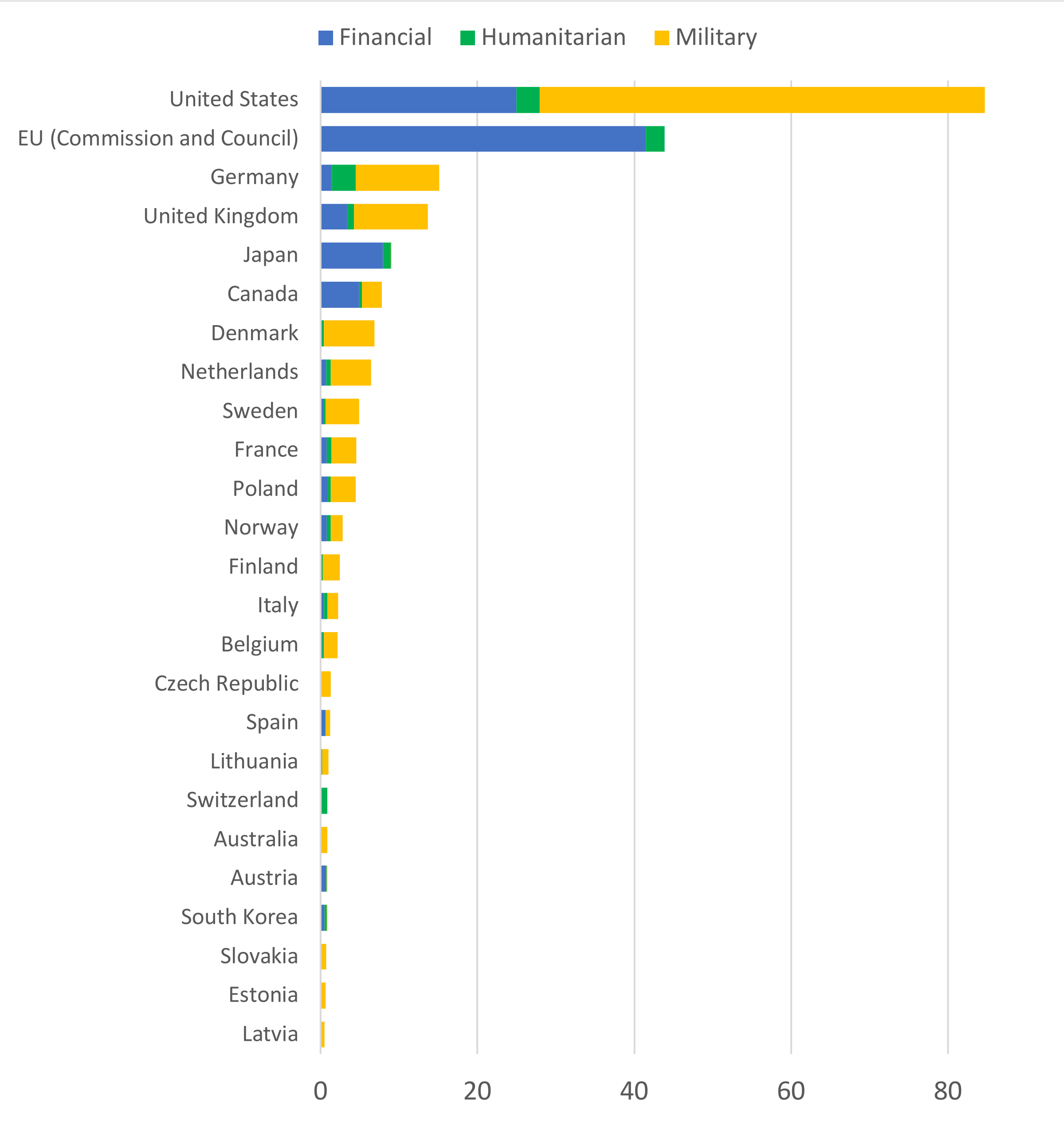
Elaboration on NATO 2024 data.

NATO Aid to Ukraine

In 2023, Ukraine's military expenditure saw a staggering increase of 51%, reaching $64.8 billion, which accounted for an unprecedented 37% of the country's GDP. This substantial rise in defence spending reflects the severe and ongoing impact of the Russian invasion, which has fundamentally reshaped Ukraine's security landscape and fiscal priorities. The dramatic surge in military expenditure is a direct response to the existential threat posed by the conflict, necessitating urgent and extensive investments in both personnel and equipment to bolster national defence capabilities. The bulk of Ukraine's increased defence budget has been allocated towards enhancing its operational readiness and sustaining prolonged military engagement. This includes significant expenditures on weapons procurement, ranging from small arms and ammunition to more advanced systems such as anti-tank missiles, drones, and artillery. The necessity to replenish and upgrade military hardware has been critical, given the extensive use and losses of equipment in the ongoing conflict. Moreover, Ukraine has made considerable investments in modernising its armed forces, focusing on areas such as training, logistics, and communications to improve the overall effectiveness and coordination of its military operations. In addition to conventional forces, Ukraine has prioritised enhancing its cyber capabilities and intelligence operations. Given the hybrid nature of modern warfare, these areas have become crucial for countering cyberattacks, information warfare, and espionage, all of which have been part of the broader strategic landscape in the conflict with Russia. The enhancement of cyber defence infrastructure and the development of robust counterintelligence measures have been critical to protecting Ukraine's military and civilian infrastructure from both physical and digital threats (SIPRI, 2024).

Ukraine's defence spending has been bolstered by significant international aid and military assistance, primarily from Western allies. Since January 24, 2022, Ukraine has received substantial bilateral aid from various international donors, including financial, humanitarian, and military contributions (see Figure 4.14).

Figure 4.14 Government support to Ukraine: Type of assistance, € billion

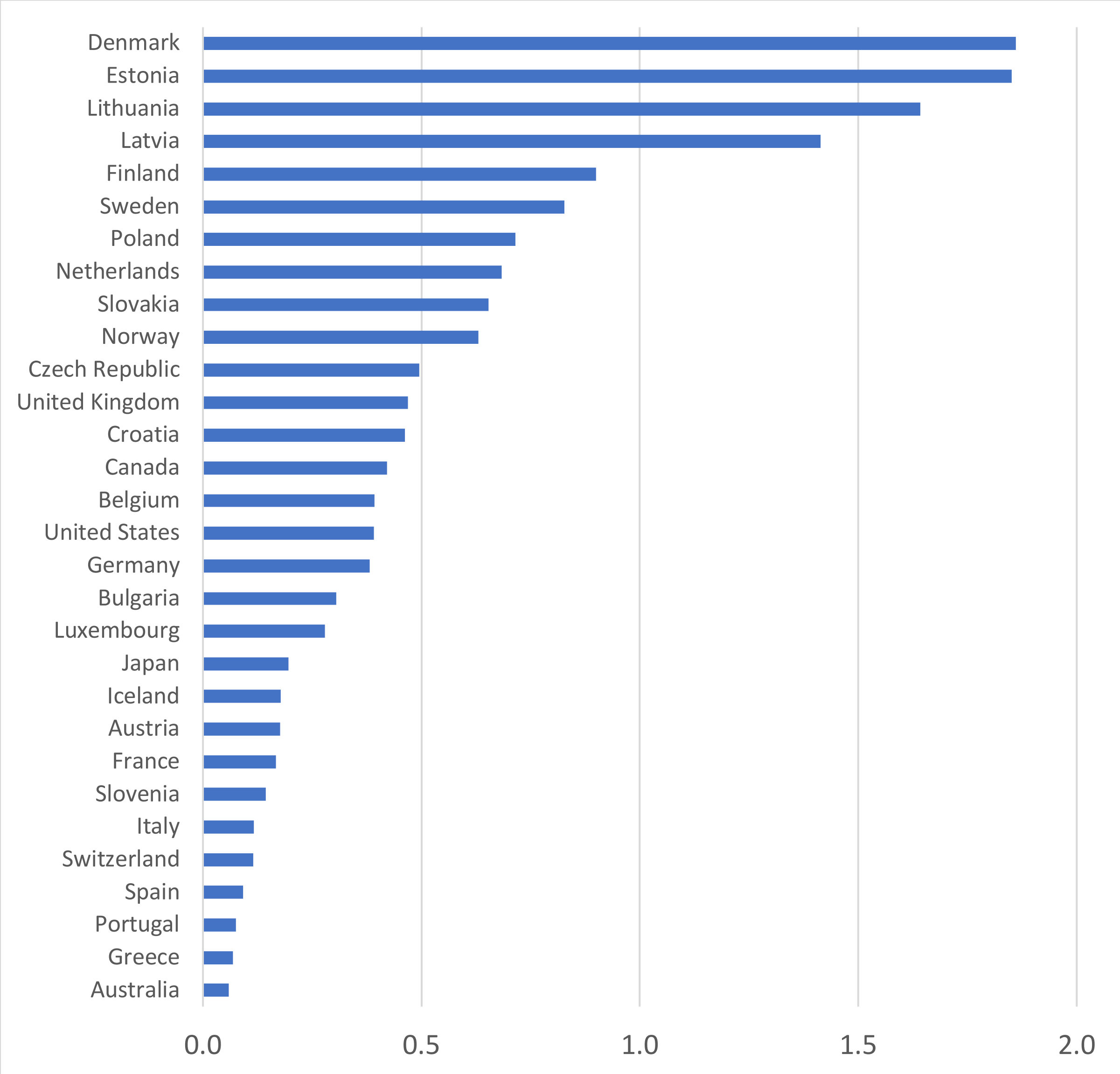


Elaboration on Kiel Institute for the World Economy 2024 data.

The United States emerged as the largest overall donor, providing a total of €84.73 billion, of which the majority (€56.80 billion) was military aid, highlighting the US's strategic focus on strengthening Ukraine's defence capabilities. Financial aid from the US amounted to €25.00 billion, while humanitarian aid was €2.93 billion. The EU institutions (Commission and Council) collectively allocated €43.83 billion, the second-highest overall, though almost entirely focused on financial aid (€41.49 billion), with €2.34 billion allocated to humanitarian aid. This reflects the EU's emphasis on economic stabilisation and governance support for Ukraine, in contrast to the direct military assistance offered by NATO countries. Germany, as the third-largest contributor, provided €15.09 billion, with its aid notably split between military (€10.63 billion), humanitarian (€3.05 billion), and financial (€1.41 billion) allocations. The United Kingdom followed closely with €13.67 billion, driven primarily by military aid (€9.42 billion) alongside financial (€3.41 billion) and humanitarian (€0.85 billion) contributions. Both countries are prominent NATO members, highlighting their commitment to Ukraine's defence and reconstruction efforts. Other notable donors include Japan, which contributed €9.02 billion, with a significant portion as financial aid (€7.93 billion), reflecting its economic support strategy. Canada's total contribution reached €7.79 billion, of which €4.89 billion was financial, €2.48 billion was military, and €0.42 billion was humanitarian. Denmark (€6.89 billion) and the Netherlands (€6.43 billion) contributed primarily through military channels, with €6.47 billion and €5.14 billion in military aid, respectively. Smaller contributors like Sweden (€4.89 billion) and France (€4.58 billion) provided significant military aid relative to their total allocations, while countries like Poland (€4.52 billion) and Norway (€2.83 billion) also prioritised military support. Humanitarian-focused donors, such as Switzerland (€0.86 billion) and Austria (€0.79 billion), directed their aid more toward humanitarian and financial assistance, avoiding military engagement. In terms of aid types, NATO countries, particularly the United States, Germany, and the United Kingdom, focused heavily on military assistance, while EU institutions and countries like Japan concentrated on financial support (Kiel Institute for the World Economy, 2024).

The data on bilateral aid allocations to Ukraine as a percentage of GDP reveals that smaller countries, particularly in Europe, have made significant contributions relative to their economic size (see Figure 4.15). Denmark (1.86%), Estonia (1.85%), and Lithuania (1.64%) top the list, showing a substantial commitment to Ukraine's defence and reconstruction efforts despite their relatively small economies. Latvia (1.41%) and Finland (0.90%) also rank highly, reflecting the strong regional support from Baltic and Nordic countries. Poland (0.72%) and Sweden (0.83%) stand out as key contributors, with aid allocations reflecting their proximity to the conflict and geopolitical interests. Larger economies such as the United States and Germany, while major contributors in absolute terms, show lower percentages relative to GDP, at 0.39% and 0.38%, respectively. This highlights the disproportionate burden borne by smaller nations, while countries like Japan (0.20%) and France (0.17%) also show more modest contributions as a share of their GDP. Italy, with a contribution of 0.12% of its GDP, falls on the lower end of the spectrum among European nations, indicating a relatively smaller economic commitment compared to its peers (Kiel Institute for the World Economy, 2024).

Figure 4.15 Government support to Ukraine: By donor country, share of GDP



Elaboration on Kiel Institute for the World Economy 2024 data.

This international assistance has been pivotal in strengthening Ukraine's defence capabilities and sustaining its military efforts. The aid has not only provided critical material support but has also facilitated the integration of advanced technologies and systems, enhancing the overall resilience and combat effectiveness of Ukrainian forces. The significant allocation of resources to the military sector has also brought challenges, particularly in terms of balancing defence needs with other critical areas of public expenditure. The high share of GDP devoted to military spending has raised concerns about the long-term economic sustainability and the potential impact on social services and infrastructure development. However, the prevailing security threats have necessitated these expenditures as a matter of national survival. Ukraine's substantial increase in military spending underscores the profound transformation of its defence strategy and posture. The ongoing conflict has not only spurred an immediate response but has also led to a broader revaluation of Ukraine's long-term security strategies, emphasising the need for a capable and modern military. As Ukraine continues to navigate the complexities of the conflict and its aftermath, the sustained focus on military readiness and modernisation remains a key priority, reflecting the deep-seated changes in the country's national defence paradigm.

NATO Military Readiness

Following Russia's invasion of Ukraine, NATO adopted a strategic concept that returned deterrence to the heart of its mission. At the 2022 Madrid Summit, the alliance outlined a series of measures aimed at strengthening collective defence with an emphasis on forward-deployed forces, high-readiness troops, and the integration of new members (NATO, 2022). These measures were intended to ensure that NATO could effectively respond to potential Russian aggression, particularly along its eastern flank. The summit marked a pivotal moment for the alliance, as it reaffirmed commitments to increasing defence spending, expanding the capabilities of forward-deployed forces, and improving the integration and readiness of its military structures.

Since the Madrid Summit, significant strides have been made in a number of key areas. As seen above, one of the most important has been the increase in defence spending among allies. Despite the progress, there are concerns about the adequacy of the 2% target, particularly in addressing critical capability gaps and reducing European reliance on the United States for collective defence. European allies, while spending more on defence, are not coordinating their efforts effectively, leading to inefficiencies and underperformance in areas such as air defence and artillery. Another significant area of progress has been the enhancement of NATO's forward defence forces. NATO's Enhanced Forward Presence battlegroups, initially established in response to Russia's annexation of Crimea, have been expanded and strengthened. These multinational forces, stationed in the Baltics, Poland, and Romania, serve as a deterrent to Russian aggression by providing a robust, combat-ready presence on NATO's eastern flank. At the Madrid Summit, NATO set a goal of scaling these forces from battalion-sized units to brigade-level formations. Several countries, including the UK and Canada, have committed to deploying brigade-sized forces in key regions, while Estonia and Latvia have conducted exercises to integrate these larger units into their national defence structures. However, progress has been uneven, with only two of the eight EFP missions having concrete plans to sustain brigade-sized forces. This raises questions about whether NATO's current forward presence is sufficient to deter a potential Russian invasion, especially given the significant local force imbalance favouring Russia in the Baltic region. In addition to strengthening its forward defence, NATO has also introduced a new force model aimed at increasing the readiness and flexibility of its military forces. The New NATO Force Model, introduced at the Madrid Summit, replaces the previous NATO Response Force and provides a much larger pool of forces—up to 300,000 personnel—that can be mobilised within 10 to 180 days, depending on the severity of the crisis. This new model significantly enhances NATO's ability to respond to a potential Russian attack by allowing for the rapid deployment of highly prepared forces across multiple domains. However, there are several challenges to fully implementing the NFM, particularly in the areas of force generation, sustainment, and command authority. NATO's ability to transfer command authority from national governments to NATO commanders in a timely manner remains a critical issue, as does the need to ensure that the forces available under the NFM align with NATO's regional defence plans. NATO's efforts to enhance its command-and-control structures have also been a key focus since the Madrid Summit. These structures are vital for coordinating the deployment and operation of high-readiness forces, particularly in the event of a crisis. There is significant progress in this area, with new headquarters established in Latvia and Poland to oversee NATO's Multinational Divisions, which are responsible for coordinating the EFP missions. Finland and Sweden's accession to NATO has required additional adjustments to command structures, particularly in the Nordic and Baltic regions. The integration of these two countries, which brings significant military capabilities to the alliance, has necessitated a revaluation of NATO's command nodes to ensure that they are capable of handling the increased operational demands posed by new members. While much progress has been made, particularly with the operationalisation of the Joint Force Command Norfolk, challenges remain in fully integrating Finland and Sweden into NATO's command structures (Monaghan et al., 2024).

The accession of Finland and Sweden represents one of NATO's most significant achievements since the Madrid Summit. Both countries bring considerable military capabilities, particularly in the Baltic Sea and Arctic regions, which enhance NATO's deterrence posture against Russia. The integration of these countries into NATO has proceeded smoothly, largely because they were already highly interoperable with NATO standards prior to their formal accession. However, challenges remain, particularly in terms of adapting NATO's regional defence plans to account for Finland's extensive border with Russia and Sweden's strategic position in the Baltic. Both countries' contributions to NATO's Article 5 collective defence obligations must be fully integrated into NATO's planning and operational structures.

Despite these advances, there are several areas where NATO still faces significant challenges. One of the most critical is the state of the alliance's defence industrial base. The war in Ukraine has exposed serious weaknesses in NATO's ability to produce and sustain key military supplies, particularly ammunition. While NATO has made progress in increasing multinational procurement and defence industry cooperation, Europe's defence industry is still plagued by inefficiencies and delays. The European Union's Defence Industrial Strategy, introduced to address some of these challenges, has helped to align NATO and EU defence priorities, but further coordination is necessary to ensure that NATO is prepared for a long-term conflict. Increased investment in critical areas such as air defence, precision munitions, and artillery is essential for NATO's ability to sustain a high-intensity conflict with a peer adversary like Russia (Monaghan et al., 2024).

While the alliance has made substantial progress in building up its defence and deterrence capabilities, particularly in terms of forward-deployed forces, command structures, and high-readiness troops, it remains vulnerable in key areas. NATO is well-prepared for a short, high-intensity conflict, but the alliance's ability to sustain a protracted war is still in question. Critical gaps in NATO's defence industrial base, logistical capabilities, and ammunition stocks could undermine its long-term warfighting readiness. Moreover, while NATO's forward presence is robust, it may not be enough to deter Russia from engaging in aggressive actions, particularly in the Baltics. NATO's journey toward full readiness is ongoing. The alliance is better prepared for conflict than it was before the Madrid Summit, but significant work remains to ensure that NATO is not only ready for war but also capable of sustaining a prolonged and high-intensity conflict. Greater cooperation among European allies is needed, including a more efficient use of defence resources and a stronger alignment between NATO and the European Union to address the challenges that remain. Ultimately, while NATO may be ready to fight, whether it is fully prepared to win a protracted conflict remains an open question.

The Precarious State of European Defence: Mario Draghi's Report

The chapter on 'Defence' from the European Commission's (2024) report titled *The Future of European Competitiveness*, authored by former ECB president Mario Draghi, outlines the importance of the EU's defence sector in securing the region's strategic autonomy and driving technological innovation. Despite the sector's crucial role, Europe faces significant challenges due to insufficient public spending, fragmented industrial structures, dependency on non-EU defence solutions, and limited access to financing. This has left the EU vulnerable in an increasingly uncertain global security environment. New and emerging geopolitical threats have intensified the need for the EU to enhance its defence capabilities. The report delves into these issues and provides proposals to address these gaps, ensuring that the EU can build a stronger, more self-sufficient defence sector.

Historically, the defence sector has been a key driver of technological innovation, producing advancements like GPS, the internet, and satellite imaging, all of which have significant civilian applications. Today, defence innovation continues to benefit non-military sectors as digital tools and technologies used in defence, like drones and artificial intelligence, find their way into civilian applications. However, the EU is not keeping pace with global competitors in defence technology, and many critical segments require investment and development. The sector remains crucial for Europe's strategic autonomy, especially with increasing global security threats and the shifting focus of the US towards the Pacific. Europe's reliance on US military and defence infrastructure has come under scrutiny, and there is growing pressure for the EU to take on more responsibility for its own defence. The EU's defence industrial base, while competitive in some areas, is still limited by structural weaknesses that inhibit its ability to meet current and future challenges, the report finds.

Public defence spending within the EU has been declining for decades, driven by a long period of peace in Europe and the security umbrella provided by NATO and the US. This prolonged underinvestment has weakened the EU's industrial capacity and left the region vulnerable. EU member states collectively spend only a third of what the US allocates to defence, which leaves a significant gap in military capabilities. In 2023, the EU's cumulative defence expenditure was $313 billion, far behind the US's $916 billion. Should all EU member states reach the 2% of GDP target, an additional EUR 60 billion would flow into defence budgets, allowing for greater investment in military capabilities and innovation (European Commission, 2024). Access to private financing is a major bottleneck for the EU's defence sector, particularly for small and medium-sized enterprises, which are crucial to innovation and supply chains. The European Commission (2024) estimates an equity financing gap of EUR 2 billion and a debt financing gap of EUR 2 billion for SMEs operating in the defence industry. Despite the European

Investment Bank Group offering financial instruments to address market failures, it largely excludes core defence activities from its financing, signalling to other investors that defence is not a priority sector. This has led to a limited flow of private capital into defence, stifling the growth of SMEs and their contributions to the industry. Furthermore, the complex regulatory frameworks governing the defence industry in Europe, particularly around procurement and production, add additional layers of difficulty for potential investors.

The fragmentation of the EU's defence industry is one of the most pressing challenges outlined by Mario Draghi's report. Europe's defence companies tend to operate in national silos, producing limited volumes for relatively small domestic markets. This fragmentation is particularly evident in sectors such as land defence, defence electronics, and naval surface vessels, where multiple EU member states duplicate capabilities rather than coordinate and integrate their efforts. For instance, Europe produces twelve different types of battle tanks, compared to only one in the US. This duplication reduces efficiency and undermines Europe's ability to scale up its defence industrial base, which is crucial for competing in the global market. Unlike the US, which consolidated its defence industry after the Cold War, the EU has been unable to achieve similar integration due to concerns over national sovereignty and an unwillingness to forgo domestic capabilities. Despite several initiatives promoting collaboration, the EU's defence industry remains fragmented, with only limited examples of structural cross-border integration. This fragmentation hinders Europe's ability to fully exploit economies of scale, reduce costs, and boost competitiveness.

A critical issue highlighted is also Europe's heavy reliance on non-EU defence suppliers, particularly from the US. Between June 2022 and June 2023, 78% of defence procurement spending in the EU went to non-EU suppliers, with 63% of that spending directed towards US defence products. This dependency stems from several factors, including the administrative simplicity of purchasing US equipment through the Foreign Military Sales program, the perceived quality and availability of US products, and longstanding political and military ties with the US. While the EU does not produce certain defence products, such as strategic airlifters or long-range missile interceptors, in many cases European equivalents could be developed. The chapter warns that continued reliance on US defence solutions may limit Europe's strategic autonomy, especially as the US adjusts its defence priorities to focus on the Pacific. Moreover, non-EU manufacturers like South Korea and Turkey are gaining traction in the European market, further increasing fragmentation and reducing interoperability among EU member states (European Commission, 2024).

The EU's defence research and development (R&D) spending significantly lags behind that of global competitors, particularly the US. In 2022, EU member states invested EUR 9.5 billion in defence R&D, while the US Department of Defence allocated $140 billion to R&D efforts. The European Defence Fund, which supports cross-border collaborative R&D efforts, contributes EUR 1.2 billion to this total, but this is insufficient to address the scale of the challenge. To remain competitive, the EU must prioritise R&D spending, particularly in areas requiring significant technological investment such as drones, cyber defence, and next-generation systems. Innovation in the defence sector increasingly relies on integrating commercial technologies from the civilian sector, particularly from SMEs. However, SMEs face significant barriers to entry in the defence market, which is often closed and dominated by national suppliers. The report emphasises the importance of developing dual-use technologies that can bridge the gap between civilian and defence applications, fostering innovation and mitigating risks through shared technologies (European Commission, 2024).

Another major obstacle to the EU's defence competitiveness is the lack of coordination and standardisation among member states. While collaborative procurement exists, it accounts for only 18% of defence equipment spending, far below the 35% target set by the European Defence Agency. The absence of standardised defence products and systems has led to inefficiencies, most notably observed during the war in Ukraine, where a variety of defence equipment from different EU countries caused logistical challenges for the Ukrainian armed forces. To address these issues, the European Commission (2024) calls for increased demand aggregation, joint procurement, and standardisation of defence products across the EU. By harmonising requirements and pooling resources, the EU can reduce duplication and inefficiency, strengthen its industrial base, and better meet future defence needs.

4.5 Preparedness Index: A Quantitative Approach

It is essential to summarise the findings from the analysis and propose a method capable of differentiating between NATO member states based on the diverse challenges they face. The **Preparedness Index (PI)** is an original composite metric designed to quantify each country's readiness to sustain an increase in short-term defence. This index achieves its objective by integrating defence-related spending indicators with key fiscal indicators, providing a comprehensive measure of a nation's fiscal capacity to support heightened defence investments.

The PI is composed of two key components:

1. **Defence Expenditure (DE)** – representing the current investment in defence as a percentage of GDP;
2. **Fiscal Component** – assessing the fiscal space in a country's government finances, which includes:
   - **Overall Balance (OB)** as a percentage of GDP
   - **General Government Gross Debt (GGGDebt)** as a percentage of GDP
   - **Real GDP Growth (RGDPG)** as an annual percentage change

By assigning specific weights to these components, the PI provides a balanced assessment of both military investment and fiscal capacity.

The PI is designed to offer a comprehensive perspective on military readiness, acknowledging that preparedness is shaped not only by defence spending but also by a nation's fiscal health and economic vitality. Defence Expenditure, the proportion of a nation's gross domestic product allocated to military spending, is the most critical variable in the formula, as it directly influences military capabilities. However, the PI also incorporates the significance of Overall Balance (% of GDP), General Government Gross Debt (% of GDP), and Real GDP Growth (% of GDP) as enabling or constraining factors for sustained military investments. A positive overall balance—indicating fiscal discipline and potential for sustainable future investments—enhances a country's score, while excessive general government gross debt exerts a negative influence on military readiness, as it restricts financial flexibility and limits capacity for military spending, particularly during economic downturns. To reflect this, General Government Gross Debt is multiplied by -0.1 in the index calculation, as high debt diminishes the fiscal space needed for defence. Conversely, Real GDP Growth, which reflects a country's economic expansion adjusted for inflation, highlights the nation's ability to generate resources for future defence investments; a higher growth rate translates to greater fiscal capacity for military expenditures.

Countries demonstrating high levels of defence expenditure, a positive overall balance, relatively low debt, and robust economic growth will score higher on the PI, indicating a stronger and more sustainable military posture. Conversely, nations characterized by low defence spending, high debt levels, or weak economic growth will receive lower scores, reflecting potential vulnerabilities in their military preparedness and fiscal health. This index provides a more holistic approach to measuring military readiness compared to traditional methods that focus exclusively on defence spending. By integrating fiscal and macroeconomic factors, the PI enables policymakers to evaluate how well-positioned a country is to maintain and enhance its military capabilities over time.

The formula for the Preparedness Index is expressed as follows:

$$PI = \alpha DE + \beta(OB - 0.1 \times GGGDebt + RGDPG) \qquad (1)$$

where $\alpha = 10$ and $\beta = 1$. The choice of setting $\alpha = 10$ reflects the importance of defence spending as the primary determinant of a nation's military capability, highlighting the direct link between financial investments in defence and the ability to maintain operational readiness, acquire advanced weaponry, and fund personnel. The choice of setting $\beta = 1$ reflects the relative importance of the fiscal factors in evaluating a country's overall preparedness and capacity to sustain military spending. By assigning a higher weight to defence expenditure, the index emphasises its critical role in influencing military capabilities. At the same time, the equal weight assigned to the fiscal component coefficient ensures that fiscal health is adequately represented in the overall assessment, acknowledging its essential role in facilitating sustained military investments.

The PI is particularly relevant in today's geopolitical landscape, where security threats are increasing and nations face pressure to expand their military capabilities. Escalating conflicts in regions such as Europe, the Middle East, and Africa highlight the need for nations to enhance their defence readiness. However, economic constraints, including rising public debt, fiscal deficits, and varying growth rates, are limiting the ability of many countries to significantly increase their defence budgets. The PI addresses this challenge by incorporating both defence spending and critical economic indicators, providing a more comprehensive measure of military readiness. The analysis of current fiscal conditions underscores the importance of balancing military investments with economic stability. Many countries are already struggling with high levels of public debt and slow economic growth, which limits their capacity to increase defence spending sustainably. The PI factors in this economic reality by assessing not just the percentage of GDP allocated to defence but also key variables such as fiscal balance, government debt, and real GDP growth. This ensures that countries scoring high on the index are not only investing in their military but are also doing so in a way that is economically sustainable.

The following are the results of the Preparedness Index for NATO countries, sorted from best to worst, obtained according to the formula and coefficients used as for Equation (1). The fiscal data is sourced from the IMF (2024a, 2024b), while the defence expenditure data is sourced from NATO (2024d).

Table 4.16 NATO Countries Preparedness Index

Countries	Defence Expenditure	Overall Balance	General Government Gross Debt	Real GDP growth	Preparedness Index
Norway	2.20	14.86	38.00	1.50	**34.54**
Poland	4.12	-5.46	55.10	3.10	**33.34**
Estonia	3.43	-3.47	23.00	-0.50	**28.04**
Latvia	3.15	-2.97	43.20	1.70	**25.89**
Lithuania	2.85	-2.60	36.20	2.20	**24.48**
Denmark	2.37	1.46	29.20	2.10	**24.38**
Bulgaria	2.18	-2.73	23.40	2.70	**19.42**
United States	3.38	-6.54	123.30	2.70	**17.62**
Sweden	2.14	-0.66	36.00	0.20	**17.37**
North Macedonia	2.22	-3.45	54.60	2.70	**16.01**
Greece	3.08	-0.93	158.80	2.00	**15.95**
Türkiye	2.09	-5.45	30.90	3.10	**15.46**
Albania	2.03	-2.16	58.00	3.10	**15.43**
Czechia	2.10	-2.22	45.10	0.70	**14.93**
Montenegro	2.02	-3.23	62.30	3.70	**14.41**
Netherlands	2.05	-1.95	47.70	0.60	**14.37**
Romania	2.25	-6.25	53.00	2.80	**13.77**
Croatia	1.81	-1.51	59.50	3.00	**13.60**
Germany	2.12	-1.52	63.70	0.20	**13.50**
Finland	2.41	-3.49	80.00	0.40	**13.06**
Hungary	2.11	-5.16	74.70	2.20	**10.68**
Slovak Republic	2.00	-5.96	59.30	2.10	**10.21**
Luxembourg	1.29	-2.06	28.00	1.30	**9.38**
United Kingdom	2.33	-4.58	104.30	0.50	**8.81**
Portugal	1.55	0.24	94.70	1.70	**7.95**
France	2.06	-4.89	111.60	0.70	**5.25**
Slovenia	1.29	-2.98	67.50	2.00	**5.18**
Canada	1.37	-1.13	104.70	1.20	**3.25**
Spain	1.28	-3.13	106.30	1.90	**0.96**
Belgium	1.30	-4.40	105.40	1.20	**-0.74**
Italy	1.49	-4.62	139.20	0.70	**-2.93**

As shown in Table 4.16, the PI reveals significant differences among NATO countries. Norway ranks first, primarily due to its robust defence expenditure and strong fiscal health—evidenced by a positive fiscal balance and low debt levels. However, using Norway as a benchmark for other NATO countries can be misleading for several reasons. Its unique economic structure, characterised by substantial revenues from oil and gas exports, enables higher defence spending without compromising other fiscal priorities. In contrast, Poland, which is NATO's highest defence spender relative to its GDP, demonstrates that despite a negative fiscal balance, its low debt and strong economic growth make its defence commitments sustainable for the time being. The Baltic states and Denmark also feature strong defence investments, coupled with historically low public debt and significant economic growth, although Estonia stands out as an exception. The United States presents a challenging fiscal outlook, marked by a negative fiscal balance and high, growing debt. Nonetheless, its substantial defence investments and strong economic growth position it favourably in the upper tier of the index. Germany occupies the lower half of the table; despite historically sound public finances, recent economic struggles and fears of recession have led to government budget reconsiderations, which may slow down the major investments needed for its military and defence sector. Further down the rankings, the UK and France, both of which have historically invested in defence, are now facing worsening fiscal conditions and low economic growth, raising concerns about their future military readiness. At the bottom of the table are countries such as Spain, Belgium, and Italy, all characterised by low defence expenditure, negative fiscal balances, and high public debt, with Italy additionally suffering from extremely low economic growth.

5. Findings and Policy Suggestions

5.1 Overview of the findings

The findings emerged from the analysis indicate that defence spending trends are deeply intertwined with geopolitical factors. The security landscape in Europe has been profoundly shaped by ongoing conflicts and regional instability, which play a critical role in shaping military budgets among NATO and EU member states. A primary driver of increased defence budgets has been the Russian invasion of Ukraine, which has catalysed a unified response from the EU in providing military aid and imposing sanctions on Russia. This urgency has led to a rethinking of defence priorities among NATO and EU states, emphasising the need for enhanced defence capabilities to address both conventional threats and non-traditional security risks such as humanitarian crises. The analysis underscores the concept of "strategic autonomy," championed by French President Emmanuel Macron, which reflects Europe's desire to reduce military dependence on the United States. However, this ambition is constrained by fiscal realities and political divisions within the EU. Additionally, the potential return of a US administration less committed to European security—such as under former President Donald Trump—raises questions about the sustainability of current defence arrangements.

The analysis suggests that, despite robust global economic growth between 2022 and 2023, defence spending faces significant challenges from macroeconomic constraints, including inflationary pressures, rising interest rates, and the need for fiscal consolidation. Although many countries have managed to avoid major economic disruptions, the medium-term outlook indicates that fiscal tightening will be necessary, particularly as public debt levels remain elevated across advanced economies. Countries like the United States and Italy will experience increased public debt driven by social spending requirements. Moreover, supply chain pressures have impacted defence procurement costs, further complicating fiscal management. While many countries have prioritised defence spending, even as inflation rates fall and monetary policies begin to ease, balancing this spending with broader economic objectives remains a critical challenge for NATO and EU members.

The findings reveal a clear upward trajectory in defence spending among NATO countries, a direct response to the escalating security threats. Notably, NATO has reached a significant milestone: for the first time in a decade, the majority of member states are projected to meet the alliance's defence spending target of 2% of their GDP. This achievement reflects a fundamental shift in the alliance's approach to burden-sharing and defence readiness, prompted by the pressing realities of the Russia-Ukraine conflict and shifting US foreign policy priorities. Historically, NATO countries committed to the 2% spending benchmark following Russia's annexation of Crimea in 2014. However, despite this commitment, many European nations struggled to meet their defence spending goals, with only the United States and a few Eastern European countries consistently reaching the target until now. As NATO approaches its seventy-fifth anniversary, it is anticipated that 23 out of the 32 member states will meet or exceed the 2% threshold, marking a notable achievement in collective defence spending.

Countries like Germany and France, once viewed as laggards in defence allocation, have made substantial commitments to enhance their military capabilities. However, while achieving the 2% target signifies progress, it raises critical questions about its sufficiency in light of evolving security threats. With Russia's military resurgence and its collaborations with nations such as China, Iran, and North Korea, there is increasing pressure for NATO to consider raising the defence spending benchmark to 2.5% or even 3%. Discussions around this adjustment are particularly urgent as the upcoming US presidential election could influence American commitments to European security, with voices from within the Republican Party suggesting that NATO members need to shoulder a more significant portion of the financial burden.

The financial challenges of increasing defence budgets cannot be underestimated. European NATO allies already contend with high taxation levels, and any significant increase in defence spending necessitates difficult trade-offs. The reality is that achieving the 2% target in many countries could involve higher taxes, reductions in social programs, or increased national debt. Given the high level of existing public spending on social welfare programs, cuts in these areas would likely provoke considerable public backlash, complicating the political landscape for defence funding. Moreover, fiscal constraints imposed by EU regulations further complicate the financial picture for many NATO members. The EU mandates that member states maintain budget deficits under 3% of GDP and public debt under 60% of GDP. Countries like Germany and the Netherlands, with relatively low debt levels, could feasibly borrow to fund increased defence expenditures. However, Germany's constitutional debt brake and the political complexities in the Netherlands complicate this process. Conversely, southern European countries with high debt loads face a precarious situation, as borrowing for defence could exacerbate existing fiscal strains. A viable alternative for addressing these financial challenges could lie in the concept of joint EU borrowing for defence. The success of the Next Generation EU program, which provided funds for economic recovery post-COVID-19, demonstrates the feasibility of collective financial mechanisms within the EU. By issuing joint debt specifically for defence spending, NATO countries could circumvent the individual fiscal constraints that limit national spending. This approach not only facilitates immediate funding for military enhancements but also aligns with longer-term goals of strengthening Europe's defence industrial base.

In summary, the analysis suggests that while defence spending will continue to rise in the near term, driven by immediate geopolitical threats, long-term sustainability remains a significant concern for policymakers. NATO and EU member states are likely to face increasing tension between maintaining robust defence capabilities and addressing broader fiscal and economic challenges. The evolving balance between geopolitics and macroeconomics will shape the future of defence policy in Europe and beyond as countries work to safeguard their security while ensuring fiscal sustainability in an increasingly complex global environment. Investing more in defence is not merely a financial imperative; it is essential for enhancing NATO's collective security and deterrence capacity against evolving threats. By taking proactive steps, NATO can strengthen its deterrent capabilities and secure a more stable and secure future for its member states.

5.2 Fiscal Strategies for European Security

Enhancing Europe's defence capabilities necessitates a two-pronged approach: an immediate increase in defence spending and the creation of fiscal space to accommodate a sustained rise in defence expenditure. This is crucial as the current security climate demands a long-term perspective, given the enduring nature of geopolitical tensions and the lengthy military planning horizons. Notably, achieving permanently higher defence spending hinges on the health of public finances. Without sustainable public finances, escalating public debt ratios would necessitate allocating an increasingly larger portion of the government budget to interest payments, potentially jeopardising future defence spending, especially during peacetime.

One strategy to create the necessary fiscal space is to finance defence spending by issuing new debt. While this approach offers a temporary solution, allowing for immediate investment in defence without requiring immediate budget cuts in other areas, it can foster a misconception that security comes without a financial burden, thereby undermining the urgency for budget adjustments. Moreover, financing defence through debt incurs interest rate costs, which can place a significant strain on government budgets in the long term. For instance, if a country aims to bridge a €10 billion annual defence spending gap over 20 years to reach the NATO target, accumulating debt to cover this gap, even at a relatively low interest rate of 2.7%, would result in an additional expenditure of €51 billion in interest payments alone after two decades (Dorn et al., 2024). Compounding this challenge is the already precarious state of public finances in numerous European countries. Soaring interest rates have drastically amplified the burden of interest payments on government budgets. Notably, seven out of 25 European countries allocated more funds to interest payments than to defence in 2023. This concerning trend is exemplified by Italy, where interest payments consumed over 7% of government spending, which is 2.7 times more than it spent on defence in 2023. This situation is particularly worrisome as it affects not only countries with historically high defence spending, such as the United Kingdom, but also those with relatively low defence spending, such as Italy and Spain (Dorn et al., 2024). Furthermore, the burden of interest payments is in danger of increasing in the coming years as governments refinance existing bonds at considerably higher interest rates.

Another strategy could be to increase taxation. While raising taxes could potentially address both insufficient defence spending and high government debt, it is crucial to acknowledge that European nations already bear a substantial tax burden. Compared to their OECD counterparts, European countries consistently demonstrate a higher tax-to-GDP ratio. In 2021, the average tax revenue relative to GDP among European NATO countries stood at 38%, surpassing Asian OECD peers by 7 percentage points and American OECD peers by a considerable 15 percentage points (OECD, 2023). This high tax burden raises concerns about potentially adverse effects on economic growth and competitiveness if taxes were to be further increased. Despite this already high tax burden, European governments have benefitted from a steadily increasing pool of funding in price-adjusted terms. This is largely attributed to economic growth, which enables governments to expand their resources without necessarily imposing a heavier burden on citizens and businesses. Conversely, increasing taxes could stifle competitiveness and hinder economic growth, ultimately undermining the intended increase in government revenue. This risk is particularly pronounced in the European context, given that taxes are already perceived as a major deterrent for businesses. In fact, 27% of European economists surveyed in the Global Economic Expert Survey identified taxes as a significant factor negatively impacting their countries' attractiveness as business locations, standing in stark contrast to less than 10% of economists in the US and Asia (Dörr et al., 2023). Furthermore, increasing taxes may be unnecessary, as government revenues are projected to increase in the coming years even without tax hikes. After adjusting for inflation, total government revenues in Europe are anticipated to rise by 1% in 2024 and 3% in 2025 compared to 2023 levels. This suggests that European governments will have approximately 200 billion euros in additional revenue by 2025, even after accounting for inflation-related increases in expenditures (OECD, 2023). This potential for increased revenue without raising taxes presents an alternative avenue for financing future defence spending. However, a modest tax increase may be justifiable for countries with a relatively low tax burden if the potential benefits of additional government revenue outweigh the costs. Nonetheless, the overarching message remains that given the already substantial tax burden in Europe, increasing taxes is not a universally viable or risk-free solution for generating funds for defence and other crucial investments.

The adequacy of defence spending in European nations hinges on their respective budgetary priorities. Insufficient defence spending can arise from two primary scenarios. Firstly, a country might have a small government budget, implying limited funding for all government functions relative to GDP. Secondly, a country might have a large government budget that simply allocates a lower priority to defence compared to other policy domains. European countries frequently exhibit the latter scenario. On average, European countries needed to allocate between 4% and 5% of their total government spending to defence in 2023 to achieve the NATO 2% target. Notably, this implies that more than 95% of government funds remained available for other policy areas. Despite this relatively small allocation required for defence, a majority of governments appear unwilling or incapable of meeting this benchmark. For instance, large economies such as Belgium, Italy, and Spain currently allocate a mere 2% to 3% of their government expenditure to defence, a significant decrease from the approximately 4% allocated in 1990. This suggests that allocating 4% to 5% of their budgets to defence in the current environment is perceived as an excessive burden on other governmental functions (Dorn et al., 2024).

Another factor to consider is public opinion. While surveys indicate that European citizens generally recognise the need for increased defence spending, their willingness to shoulder the associated costs is less certain. On the one hand, there is clear evidence of public concern about European defence capabilities. Across Europe, approximately two-thirds of survey respondents agree that the European Union should allocate more funds to defence. Significantly, in every single country surveyed, this view garners support from more than half of the citizens. This suggests a widespread understanding of the evolving security landscape and the need for a more robust defence posture. However, when asked specifically about their own country's defence spending, citizens express more nuanced views. While a majority supports increased defence spending at the European level, this sentiment does not necessarily translate into a willingness to bear the costs at the national level. Only in four countries does a majority favour increasing their own country's defence budget (Eurobarometer, 2023). This discrepancy suggests that while citizens might acknowledge the general need for greater defence spending, their support wanes when confronted with the potential financial implications at home. Furthermore, there is a degree of volatility in public opinion. While support for increased defence spending surged in the immediate aftermath of Russia's invasion of Ukraine, this initial wave of enthusiasm appears to be receding in many countries. This trend underscores the fragile nature of public support, particularly in the absence of an immediate and tangible threat (NATO, 2023). These dynamics can be illustrated through the case of Germany, a country that has witnessed both a substantial peace dividend since 1991 and a significant shift in public opinion following the Ukraine war. While support for higher defence spending in Germany rose to 59% in 2022, a majority in the same survey also expressed support for increased funding in seven other policy areas. This simultaneous demand for both higher defence spending and increased investment in other domains underscores the difficult trade-offs governments face in allocating limited resources. Interestingly, a survey of German economics professors revealed a preference for fiscal consolidation as the primary means of financing defence spending, with 71% supporting this approach. In contrast, only 33% favoured raising taxes, and a mere 16% supported debt-financed defence spending. However, despite their willingness to consolidate public finances, these economists remained reluctant to identify specific areas for budget cuts (Gründler et al., 2023). This hesitation to make difficult choices mirrors the broader public sentiment, highlighting the challenge of translating support for defence spending into concrete policy action. This paints a picture of evolving and potentially fragile public support for defence spending. While citizens generally recognise the need for increased investment in defence, their willingness to accept the costs remains contingent on various factors, including the perceived level of threat and the potential impact on other policy areas. Governments will need to carefully navigate these complex dynamics, effectively communicating the necessity of defence spending while addressing concerns about costs and trade-offs.

5.3 Policy Suggestions

Fiscal Policy Sustainability in a Geopolitically Complex Environment

The global fiscal landscape faces complicated challenges, driven by heightened spending pressures from geopolitical tensions, economic shocks, and structural factors like ageing populations and climate change. Balancing the need for increased defence spending, especially in Europe and other regions, with long-term fiscal sustainability is critical. Governments must find ways to manage these rising expenditures without undermining economic stability. Achieving fiscal sustainability means ensuring that revenues align with long-term expenditures. A failure to manage this balance will lead to fiscal imbalances, making economies more vulnerable to future crises. Projections indicate that spending pressures—particularly from defence, healthcare, social welfare, and environmental adaptation—will continue to grow, with an increase of 7% of GDP in advanced economies, 9% in emerging markets, and 14% in low-income countries by 2030 (IMF, 2024b). Without careful planning, these growing financial commitments will place immense pressure on governments already dealing with high public debt levels. By 2023, many advanced and emerging market economies had failed to stabilise their debt-to-GDP ratios, with fiscal deficits exceeding safe thresholds in 32% of advanced economies and 41% of emerging markets. Projections show that without corrective action, these imbalances will persist through 2029, requiring primary deficit reductions of approximately 1% of GDP for advanced economies and 2.1% for emerging markets to prevent rising debt (IMF, 2024b). Addressing these fiscal imbalances will require a combination of revenue mobilisation and spending reforms. Governments must modernise tax systems, broaden tax bases, and ensure that public spending is efficient and well-targeted.

Detailed Policy Recommendations for Fiscal Consolidation:

- **Phasing Out Crisis-Era Measures:** Governments must systematically eliminate temporary measures introduced during crises, such as COVID-19. These discretionary policies were critical in supporting economies during the pandemic but now contribute to unnecessary fiscal strain. For instance, subsidies for energy and fuel, often politically motivated, should be phased out and replaced with more targeted social programs. Governments should ensure that vulnerable populations are protected through social safety nets, but without maintaining broad-based and inefficient subsidies that distort markets and strain public budgets. The savings generated from such reforms should be redirected toward essential long-term investments in infrastructure, education, and health services, thereby improving the overall fiscal health of economies.

- **Reforming Social Spending:** In advanced economies, demographic shifts, particularly ageing populations, will result in growing healthcare and pension costs. Policymakers must reform entitlement programs to ensure long-term sustainability. This can be done by increasing retirement ages in line with life expectancy, indexing benefits to inflation rather than wage growth, and improving the efficiency of healthcare systems through digital transformation and preventive care programs. In emerging markets and low-income countries, reforms should focus on reducing public-sector wage bills and improving the targeting of social safety nets. By digitising welfare distribution systems, governments can eliminate fraud and inefficiencies while ensuring that benefits reach those most in need. This will help governments create fiscal space for other critical areas, such as education, infrastructure, and defence.

- **Strengthening Revenue Mobilisation:** Governments must align revenues with growing expenditure needs by improving tax systems. Rather than relying solely on higher tax rates, policymakers should focus on expanding tax bases and making tax collection more efficient. For example, adopting the OECD's Inclusive Framework on Base Erosion and Profit Shifting (BEPS), including a global minimum corporate tax, can help address tax avoidance by multinational corporations and raise significant additional revenue. Additionally, governments can implement digital technologies to streamline tax administration, reduce evasion, and increase compliance. Reforms that simplify tax codes and reduce administrative barriers can help broaden the tax base, thereby increasing revenues without stifling economic growth.

- **Implementing Credible Fiscal Frameworks**: A long-term solution to fiscal instability requires governments to adopt medium-term fiscal frameworks that are credible, transparent, and adaptable to risks. These frameworks should set clear targets for deficit reduction, public debt stabilisation, and expenditure management. Independent fiscal institutions, such as fiscal councils, can provide oversight by evaluating budgetary performance, analysing fiscal risks, and ensuring that governments adhere to fiscal rules. For instance, such institutions could assess the economic assumptions underpinning government budgets, ensuring that they are realistic and that debt sustainability plans are grounded in robust analysis. Strengthening public financial management systems, including enhancing the transparency of debt reporting, is essential for building trust and preventing unsustainable borrowing practices. This also includes reporting on the composition of creditors and the terms of debt, which is crucial for understanding a country's fiscal risks.

Sustainable Defence Spending in Europe

As said above, the current geopolitical climate, particularly in Europe, has necessitated a reassessment of defence spending. With ongoing conflicts like the war in Ukraine and shifts in US foreign policy, European nations must increase their defence budgets to safeguard their security. However, relying on debt or raising taxes to fund these defence expenditures is not a sustainable long-term solution. Rising interest rates and already high public debt levels exacerbate the financial strain, as seen in countries like Italy, where interest payments alone exceed defence spending. Policymakers must carefully balance defence needs with fiscal sustainability. Raising taxes risks undermining economic growth, especially in European countries where tax burdens are already high. Instead of relying on short-term fixes, Europe must adopt a more comprehensive approach that emphasises efficient allocation of defence resources and increased cooperation among member states.

Detailed Policy Recommendations for Sustainable Defence Spending:

- **Implement Growth-Friendly Policies**: Implementing growth-friendly policies is crucial for sustaining defence and social welfare spending. Policymakers must prioritise measures that foster innovation, attract investment, and enhance productivity. This includes increasing funding for research and development in defence technologies, as highlighted in the EU defence proposals. By focusing on innovation and investing in digital infrastructure, the EU can improve its long-term growth potential. Additionally, creating a favourable business environment by reducing unnecessary regulatory burdens and encouraging entrepreneurship within the defence sector is essential. These actions will not only drive economic growth but also strengthen the revenue base needed to finance defence and social programs without resorting to higher taxes or additional borrowing.

- **Maintain Solid Public Finances**: Maintaining solid public finances is equally important. Fiscal discipline is vital to ensuring manageable public debt levels, and governments must adhere to responsible budgeting practices and implement debt reduction measures when necessary. In the realm of defence, this means swiftly implementing the European Defence Industrial Strategy (EDIS) to ensure fiscal responsibility. By setting clear limits on deficit spending and establishing contingency funds, governments can better manage financial crises without resorting to unsustainable debt-financed defence expenditures. Responsible budgeting in defence spending will allow governments to maintain financial stability while ensuring adequate funding for essential defence needs.

- **Curtail Consumption Spending**: To achieve a sustainable defence budget, curtailing government consumption spending, especially in areas prone to inefficiencies, such as entitlement programs and subsidies, is essential. Policymakers must scrutinise social welfare programs to ensure they are efficient and sustainable. One way to achieve this is through collaborative procurement and resource pooling among European countries. Joint military procurement and the establishment of shared defence infrastructure, such as training centres or research facilities, can generate significant cost savings by avoiding duplication and taking advantage of economies of scale. By phasing out ineffective subsidies and redirecting resources to critical defence and infrastructure needs, governments can better balance social and defence expenditures.

- **Strengthen Defence as a European Public Good**: Strengthening defence as a European public good should be a collective responsibility among EU member states. By pooling resources and enhancing collaboration, European nations can achieve better security outcomes at a lower cost. Enhanced coordination on defence projects, particularly in research and development, can ensure Europe maintains its defence posture without overburdening individual national budgets. For instance, standardising and harmonising defence equipment among member states can significantly improve the efficiency of defence expenditures. Recognising defence as a European public good also allows member states to share the financial burden more effectively, promoting shared responsibility and a more strategic allocation of resources across the EU defence sector.

Achieving fiscal sustainability amid rising defence needs and structural challenges requires thoughtful planning and prudent fiscal policies. Governments must reform social spending, modernise tax systems, and adopt credible fiscal frameworks to balance short-term defence requirements with long-term economic stability. In Europe, enhanced cooperation in defence spending and fiscal discipline will be essential for maintaining security while safeguarding economic resilience. By adopting a multifaceted approach, governments can meet both defence and social priorities in a fiscally sustainable manner.

6. Conclusions

As we draw the research to a close, it is clear that the balancing act between national security and fiscal responsibility is more complex and pressing than ever. NATO member states find themselves navigating turbulent geopolitical waters, where emerging threats necessitate significant military investment, yet the weight of public debt and budgetary pressures pull in the opposite direction. This intricate dance between financial limitations and security imperatives serves as the backdrop to this dissertation, where we have explored how NATO countries, particularly in Europe, are striving to secure their futures without derailing their economies.

Throughout the course of this study, we have traced the historical shifts in NATO's defence spending. Starting from the Cold War's peak, where military budgets soared, through the post-Soviet era of defence cuts, to today's urgent calls for renewed military investment in the face of rising geopolitical threats like Russia's invasion of Ukraine. At the heart of NATO's current challenge is the 2% GDP defence spending target, a political commitment that symbolises the alliance's resolve to remain strong and unified. Yet, as this dissertation has shown, hitting that target is far easier said than done for many NATO members. A key theme that has surfaced in the analysis is the constant push-and-pull between fiscal discipline and security demands. Many NATO countries are facing enormous fiscal challenges, including soaring public debt, sluggish economic growth, and inflation, and are forced to juggle between funding increasing investments in defence and delivering essential public services like healthcare and education. This dilemma is particularly acute in Europe, where the economic strain from the COVID-19 pandemic has increased the already high public expenditure of governments, making the path to increased defence spending steep and fraught with difficult trade-offs. But this challenge is also about strategic autonomy, public sentiment, and the broader geopolitical dynamics reshaping Europe and beyond. The EU's growing desire for strategic autonomy reflects a region keen to stand on its own two feet militarily. However, this desire is tempered by the reality that Europe still heavily relies on US military support, and consensus on the best path forward remains elusive among EU member states. The result is a complicated, sometimes contradictory defence policy that NATO must manage if it is to remain a strong, cohesive force. Despite these challenges, NATO countries are finding solutions to ensure that defence capabilities are enhanced. Collaborative defence initiatives, such as joint procurement and resource sharing, have emerged as a pragmatic way for countries to efficiently spend their military budgets. By pooling resources, NATO members can maintain and even enhance their defence postures while keeping budgets in check. The concept of the Preparedness Index, introduced in this dissertation, also offers a practical tool for assessing which NATO countries are best positioned to ramp up defence spending in response to new threats. This tool highlights the disparity within the alliance, where some countries are well-prepared to meet their 2% spending target, while others lag behind due to economic limitations.

Defence spending isn't just about meeting today's security needs; it's also about preparing for an increasingly unpredictable future. NATO's defence planners are being asked to navigate a fast-evolving threat landscape that includes not just conventional military threats but also cyber warfare, terrorism, and the ripple effects of climate change. The pressure is on countries to invest smartly, ensuring that their defence strategies are both sustainable and flexible enough to adapt to whatever new challenges arise. The policy recommendations in this dissertation emphasise the need for a careful balancing act: maintaining strong defence capabilities without undermining economic stability. Achieving this requires governments to pursue disciplined fiscal policies, avoid over-reliance on debt, and invest in areas that can foster economic growth, such as advanced technologies. Looking ahead, it is clear that NATO faces an uncertain future. The alliance has shown remarkable resilience in the face of geopolitical turbulence, and the rising defence budgets across Europe are a sign of a collective awakening to the reality of modern security threats. However, long-term sustainability will depend on continued innovation in how countries approach their defence obligations. More than ever, NATO needs strategic foresight and agility, and this will require both national governments and NATO as a whole to make difficult, forward-thinking decisions.

In wrapping up this dissertation, it is worth reflecting on the broader significance of these findings. Defence spending is not just a question of military readiness; it is also a reflection of a nation's values, its priorities, and its willingness to shoulder the responsibilities that come with maintaining peace and stability. For NATO countries, particularly those in Europe, the challenge moving forward will be to strike the right balance between safeguarding their people and preserving their economic health. Policymakers will need to craft strategies that allow for both robust defence postures and economic resilience, ensuring that NATO remains capable of addressing the ever-growing list of security challenges on the horizon.

Ultimately, this research highlights the importance of continued dialogue and cooperation within NATO. The future of the alliance will depend not just on how much money its members are willing to spend but also on how wisely they invest it and how effectively they collaborate. The coming years will undoubtedly bring new challenges, but with the right mix of foresight, innovation, and shared commitment, NATO can continue to thrive as the bedrock of international security in a rapidly changing world.

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