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# European Defence from the Perspective of Fiscal Federalism – A Case for Military Integration?

## Abstract

The integration of EU Member States' militaries has come to the forefront of political discussions in recent years, especially since the Russian invasion of Ukraine on February 24th, 2022. This paper employs the theoretical lens of fiscal federalism to clarify and weigh the arguments for and against military integration in Europe. Centralised provision of deterrence would overcome many of the inefficiencies of European deterrence production, but Member States' diverging preferences for security production incentivise against integration. The paper finds nonetheless that interjurisdictional spill-over effects of military integration indicate that EU defence would be organised the most efficiently and with fair burden-sharing at the EU level. Such a development is nonetheless unlikely in the context of the current divergence of preferences among the Member States and a renewed focus on NATO.

*Keywords:* Common Security and Defence Policy (CSDP), European Military Integration, Fiscal Federalism, European Public Goods

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## Introduction

The Russian neo-imperialist invasion of Ukraine is not only an attack on Ukraine's independence and democracy but also aims directly at the post-Cold War security architecture in Europe. It is "the West's biggest test since World War II" (Hirsh 2022), and will likely lead to a significant increase in military expenditures – German Chancellor Olaf Scholz's explicit commitment to the North Atlantic Treaty Organization's (NATO) two per cent spending goal as a case in point – and a reshaping of NATO and European Union (EU) policies to deter Russia in and beyond Ukraine. While the trans-Atlantic bond seems firm in its reaction to the Russian invasion, the political climate in the US is volatile.

As such, the Russian war against Ukraine also acts as a catalyst for discussions on the role of the European Union as a defence actor. These discussions, warranted by the US' strategic reorientation to the Asia-Pacific region, and the turbulences of the trans-Atlantic relationship under Trump, strongly recommended deepening military integration. Most exemplary here is the joint paper by the French and German Ministries of Finance, which has identified a common military market and culture as one of eight top priorities for the EU (Fuest and Pisany-Ferry 2019). With the renewed urgency of the question, this paper investigates the pros and cons of military integration from the lens of fiscal federalism.

Fiscal federalism seeks to identify the optimal level of provision of a public or semi-public good in a federal state structure (Oates 1972). The theory weighs the potential economies of scale – as an incentive for centralisation – and the degree of heterogeneity of preferences, to which a decentralised provision would be more responsive. Taking into account interjurisdictional externalities, the optimal level of government is identified according to fiscal correspondence, meaning that level of government where those benefiting from and those paying for a particular public good are congruent (Oates 1999). Translated back to the context of EU military integration, the paper asks *at which level – Member State or supranational – European defence can be optimally provided*.

The lens of fiscal federalism is fitting for the case of European defence: Defence is a classic example of a public good (Olson and Zeckhauser 1967, 25), and the EU as a supranational organisation *sui generis* represents a federal structure, even in relatively intergovernmental policy fields such as the Common Security and Defence Policy (CSDP): Since the Maastricht Treaty, the EU pursues a common defence policy, EU-level command infrastructure has been created at the Council, there has been partial harmonisation of defence procurement, and the EU has deployed over 30 joint missions through the CSDP framework (Gegout 2010).

Deeper military integration is, however, not a dichotomous yes-or-no question, but best understood on a continuum. The EU already engenders a military alliance since the Lisbon Treaty has come into effect, which represents a form of joint defence without any integration of military structures. Integration could be *partial*, focusing on the supply side of defence markets and procurement. *Full* military integration would entail the integration of the military forces themselves, including control and command

structures, and would represent a full supranationalisation of the EU military capabilities.

Fiscal federalism allows to weigh the potential efficiency gains of partial or full military integration against the reduction of the sovereignty of the Member States. The paper thus takes a step back and interrogates the desirability of military integration from a politico-economic perspective. It finds strong arguments for integration, as it could greatly increase the efficiency of European defence spending and deterrence production and distribute the burdens of defence spending more fairly. However, this crucially depends on the political coordination between Member States and NATO partners, to accommodate the diverging preferences of Member States.

The next section will quickly delineate the state of the art of European military integration, and present the leading theories in accounting for the recent rise in integration efforts, neofunctionalism and the research on the integration of core state powers. The third section shines a light on the individual elements of the theory of fiscal federalism: economies of scale in defence research, development, and procurement call for a centralised provision; the heterogeneity of threat perceptions and preferences concerning strategic national autonomy and the relationship with NATO that favour a decentralised provision; and the implications of spill-overs for fairness of burden-sharing and cooperation through common strategic culture. The paper ends with a discussion of the likelihood of military integration, and a conclusion.

## European Defence Cooperation

During the Cold War, European defence cooperation was organised outside the EU framework through the Western European Union (WEU), which was however largely overshadowed by NATO during its existence. After the end of the Cold War, EU defence cooperation received new impetus that found its expression in the Treaty of Maastricht (1992), where Member States agreed on the creation of the Common Foreign and Security Policy, of which the CSDP became an integral part. The Treaty envisioned a military defence alliance and called for the EU to

> "assert its identity on the international scene, in particular through the implementation of a common foreign and security policy, including the eventual framing of a common defence policy, which might in time lead to a common defence." (Treaty of Maastricht 1992, Title 1.B)

Over the next two decades, the provisions for common European defence were strengthened further. The 1998 Franco-British Saint-Malo Declaration marked the starting point for transferring the tasks of the WEU to the EU under its CFSP structure. The EU created a European Rapid Reaction Force in 1999 (Bickerton et al. 2011), deepened the CSDP's institutional framework with the military staff committee and the military committee in the Council structure in Brussels (Gegout 2010), and conducted

its first CSDP missions in the Former Yugoslav Republic of Macedonia and the Democratic Republic of the Congo (Piccolino 2010).

These developments were further strengthened by the Lisbon Treaty, which took over the WEU's mutual defence clause, elevating CSDP to a proper military defence alliance and dissolving the remnant of the WEU into the EU (Treaty of Lisbon 2009, Art. 42). Furthermore, tentative steps at the integration of defence markets have been pushed for by the European Commission in this context. Through two directives on the intra-EU transfer of defence equipment and on Member States' defence procurements in 2009, the scope for the exclusion of defence procurement matters from common market rules, provided for under Art. 346 of the Lisbon Treaty, was limited (Fiott 2017; Weiss 2013). Blauberger and Weiss (2013) have documented how the Commission strategically used the threat of court-driven integration to cajole originally hesitant Member States into agreeing to the directives, indicating both the sensitive nature of defence cooperation and the increased profile of supranational institutions in it.

The latest significant defence initiative at the EU level was the 'defence package' in 2017 as part of the operationalisation of the EU's Global Strategy. For one, the Permanent Structured Cooperation (PESCO) envisioned by the Treaty of Lisbon was activated by a Council Directive in 2017, providing for the gradual deepening of defence cooperation through an increase in "joint and collaborative defence capability development projects" between the 25 Member States participating, with Denmark and Malta opting out (Council of the European Union 2017). This enhanced collaboration was substantiated by the Coordinated Annual Review on Defence (CARD), which seeks to take stock of existing defence capabilities and identify promising areas of cooperation (European Defence Agency n/d).

Member States also agreed to establish the European Defence Fund (EDF) to coordinate national research and development projects in the area of defence (Ianakiev 2019), which became operational in 2021 (European Commission 2021). Taken together, PESCO, CARD, and the EDF represent a significant step towards stronger EU defence cooperation and indicate a stronger role of supranational institutions such as the Commission in defence matters (Håkansson 2021). This lends further salience to an analysis of EU defence as provided through a federal structure.

The deepening of defence cooperation has been explained from a variety of theoretical lenses in the literature. In the long-dominant theory of European integration, neofunctionalism, integration dynamics are explained as the product of spill-over effects[1] from one policy field to another (Nicoli 2020). After a policy field has been integrated, the interdependence of policy fields creates integration pressure in another policy field because of the functional relationship between the policy fields and because it empowers supranational actors to pressure for further integration (Bergmann 2019).

[1] Note that neofunctionalist spill-over is different from spill-overs in fiscal federalism. In neofunctionalism, spill-overs refer to integration pressures stemming from the interdependence of policy fields, whereas fiscal federalism understands spill-overs as interjurisdictional externalities of a specific policy field.

In defence, this stems from the partial integration of foreign and defence policy, which reduces the ability to organise effective national policies while not allowing for effective decision-making at the European level (Håkansson 2021).

There are four types of spill-over effects: functional spill-over occurs when the goal of a more active role of the EU in security and defence matters could not be achieved without further integration, political spill-over when national elites can only resolve policy challenges at the supranational level and cultivated spill-over when supranational institutions act as the driver of integration for self-empowerment. Lastly, exogenous spill-over refers to outside factors that increase the overall demand conditions for integration (Håkansson 2021). Håkansson finds some evidence for these kinds of policy spill-over in defence policy, mainly exogenous driven by the US pivot to Asia, and cultivated as the Commission framed defence matters as questions of economics to allow itself to play a bigger role (Håkansson 2021, 590–92).

Another important contribution comes from the research agenda of Genschel and Jachtenfuchs (2013), which focuses specifically on the integration of core state powers. This theoretical focus identifies the particular demand and supply conditions that lead to drives for integration. In the case of military integration, these demand conditions are generally identified as the necessity to prevent free-riding through regulatory integration and to increase interoperability between European militaries. More generally, European militaries have reoriented towards smaller, more mobile and professional forces, which need to operate well in joint and cooperative missions. Another demand condition is the potential symbolic legitimacy of European military action that national-level activities often cannot provide (Mérand and Angers 2013).

These demand conditions of a collective action problem that "is so evident that it defies the mind" (Mérand and Angers 2013, 58) have only partly been met by the supply conditions, which refer to "actors capable and willing to effectively increase the level of integration" (Genschel and Jachtenfuchs 2013, 10). In defence cooperation, the supply side has mostly been driven by political or diplomatic objectives, such as the Franco-German Brigade, driven by Chancellor Helmut Kohl's and President François Mitterrand's desire to demonstrate reconciliation. Another driver supplying integration of defence has been non-majoritarian institutions such as military planners, who have used political momentum to establish benchmarks and provide a limited convergence on military structures, procedures, and norms (Mérand and Angers 2013).

Nonetheless, these efforts still fall significantly short of full or even partial military integration – Member States retain their own militaries, command structures, defence industries, and defence ministries. This does not per se pose a problem to the provision of common defence, which can be organised both through a military alliance as embodied in the Lisbon Treaty as well as by a partial or full integration of the militaries of Member States. The question is rather at which level of government – national or supranational – the public good of European defence can be provided in the *most efficient and fair way*.

The theory of fiscal federalism provides the right tool to answer this question. It partly corresponds to the supply and demand conditions identified by Gerschel and Jachtenfuchs,[2] but formulates them in a broader analytical frame which seeks to identify the right level of government for the provision of a specific public good. Defence is a clear example of a public good, with non-rivalry and non-excludability in consumption (Musgrave 1994; Samuelson 1954), and the theory of fiscal federalism is thus well equipped to map and evaluate the arguments in favour of the central or decentralised provision.

## Fiscal federalism – determining the optimal level of government

The theory of fiscal federalism analyses the optimal level of government from a politico-economic perspective. Economies of scale lie on the supply side of this equation and compare the added value created by organising provision on a higher level of government. Similar to economies of scale in a factory, where larger production volumes mean that the production cost per unit falls, it is thus concerned with the level of government that can produce a specific good in the most cost-effective way (Oates 1972). Applied to the case of defence, economies of scale impact how effective one unit of military capabilities and capacities can be produced at the EU level, in comparison to the level of the Member States (Murdoch 1995).

The heterogeneity of preferences is the corresponding principle on the demand side of the provision of a mixed public good. If the individual federal entities have divergent preferences for how the mixed good should be provided, this strongly calls for a decentral provision – if entity A wants to provide the good in another fashion than entity B, they should each take care of their own provision of the good, broadly corresponding to the political principle of subsidiarity. With regards to the provision of defence, individual Member States may vary widely in what they perceive as a threat to their national security and in the way they deem appropriate for answering this threat.

The third element under consideration, spill-over effects, serve as a mediating factor between the demand side and the supply side. Spill-over effects, or externalities, describe how the benefits from the provision of a good in one Member State also benefit another Member State. If the provision of a good is too decentralised, this may lead to an underproduction of the good as the benefits to non-members of the entity are not taken into account. Moreover, spill-over effects may make a strong case for centralisation to ensure that those financing and making the decisions on a particular public policy correspond to those benefiting from the provision of the good (Oates 1972).

[2] Note that the supply and demand side of fiscal federalism concern the provision of the public good, and are different from the supply and demand conditions of the integration of core state powers, which concern the dynamics of integration.

## Economies of scale – the supply side of deterrence provision

Economies of scale refer to the ways in which (military) spending becomes more efficient when organised at the federal level. The production of deterrence is cheaper if organised from the centre in larger production volumes, which would ease every Member State's budget constraint, allowing for an increase in deterrence or social spending. This is where significant economies of scale can be provided by pooling resources, which influences the price per unit of a military good. Pooling resources, therefore, allows all allies to either produce more military output with the same investment or to maintain the same military output while spending less on it.

This is all the more relevant as unit costs for production of and research into military goods have followed a steep upward curve ever since the end of the Cold War, while military budgets – particularly in Europe – have decreased (Hartley 1995, 2003, 2016). While the trend of decreasing military budgets seems to have reversed slightly, research and development spending will likely continue to increase at a faster pace, as disruptive and emerging technologies become a central asset in a security landscape that needs to answer hybrid and cyber threats not well-captured by conventional understandings of territorial defence (Béraud-Sudreau and Giegerich 2018).

Despite these pressures, the European defence market is still highly fragmented. National ministries of defence remain at the helm of procurement decisions. As a result, the wide array of weapons, ships, jets, and planes in use among the European countries is staggering: there are 17 different tanks (compared to one in the US military), 29 warships (compared to four) and 20 fighter planes (compared to six) in use among the EU Member States (Mogherini and Katainen 2017). This is highly inefficient as there are significant economies of scale at play in the procurement process: If the order is larger, the price per unit will drop.

Such economies of scale could be substantiated within a free and common European defence procurement market, where specialisation could take place and all Member States would benefit from the respective comparative advantages individual Member States hold (Olson and Zeckhauser 1967). Already, individual Member States are known to produce certain goods more effectively than others. In a common European market the best technology – German armoured vehicles, French combat aircraft, and Dutch naval escort forces, for example – would be available to all other Member States at the most competitive price (Hartley 2016). The European Commission estimates this deadweight loss in the procurement market alone around 30 billion € – more than a staggering 10% of the total military budget by EU Member States (Mogherini and Katainen 2017).

Similar economies of scale can be achieved in the area of research and development (R&D). Here, several developments amount to a significant potential increase in the output per euro spent. As mentioned above, the trend towards more high-end military technology will likely continue. This could potentially even lead to R&D spending below a necessary critical mass for the individual Member States – meaning that the spending would lose basically all effectiveness because of a level of funding that does not allow

efficient research or limit Member States' ability to adopt important military innovations (Ianakiev 2019).

Third, there are significant deadweight losses in duplication similar to those in the area of procurement, well-evidenced by the example of combat aircraft. Over the last ten years, three different types of combat aircraft have been under development in the EU: The French Rafale, the Swedish Gripen, and the British-German-Italian-Spanish collaborative Eurofighter Typhoon project. Had there only been one European combat aircraft development, and assuming that it would have realised the same amount of sales as the other three aircraft projects have, the R&D costs per unit would have decreased by 41 to 76% (Ianakiev 2019, 13).

There are significant potential economies of scale in procurement and R&D, and these economies of scale are available if resources in procurement and R&D are pooled, irrespective of whether the EU would also integrate its military administration and command structures. Even steps towards partial military integration, focused on integrating defence markets and engaging in joint procurement, however, have been complicated by the heterogeneity of preferences among the Member States in the past.

## Preference heterogeneity – the demand side of deterrence provision

Having established that the economies of scale in the pooling of European military spending are sizeable begs the question of why it has not occurred. This concerns the demand on the side of the national governments, which concerns the political reasons for which these governments refrain from pooling their resources. There are three central arguments for Member States to retain their national military forces: protection of national key industries, heterogeneous threat perceptions and defence priorities, and the relationship of an integrated European military to NATO. They will each be presented in turn, showing that there is a strong heterogeneity of preferences that favour decentral provision of the military good of deterrence.

The protection of key industries has two facets: military self-sufficiency and electoral gains. Military self-sufficiency is a strong argument in this case because a common market for defence production foresees a specialisation, which is desired for economies of scale but may also mean that certain less competitive producers are forced out of the market even though they have a strong strategic value for national defence production (Olson and Zeckhauser 1967). Defence production always has a strategic component – it is obvious, for instance, that any nation A would not want to be dependent on imports from nation B for essential military products – otherwise, they would be left without essential military equipment if the relation between nations A and B worsens. Therefore, many governments protect their own industries through market entry barriers, preferential purchasing agreements, and technology transfer restrictions (Hartley 1995). Independence and security of supply weigh heavily when the goods in question are essential to state survival in the case of crisis.

Even if these concerns about national independence were done away with by strong alliance and mutual trust and reassurance, an electoral incentive remains for governments to maintain national industry protection: jobs. In 2014, the defence industry employed around 500,000 people directly, while indirectly generating 1,200,000 jobs. These jobs are not evenly dispersed, but mainly sit within Austria, the Czech Republic, France, Germany, Italy, Poland, Spain, Sweden, and the United Kingdom (Roth 2017). From these jobs, and the exports created in these industries, flows another important incentive against military integration – government revenues. Similar to the location of the defence industry, their relevance to government revenues also diverges significantly among the Member States.

While in any Member State the electoral incentive for governments is to protect their national markets against job loss and to maintain tax revenue, ultimately also shielding against potential consequences at the ballot box, this incentive is particularly high in countries where the market is characterised by Small and Medium-Sized Enterprises, such as Poland and the Czech Republic. In these countries, the respective importance of the defence industry for national GDP and employment is comparatively high, while their competitiveness in a common market is significantly lower than that of their Western and Northern European counterparts (Kolín 2015). In a situation where the relative wins and losses of integration are unevenly distributed, there are strong incentives for relative losers to oppose integration, even in the face of significant potential economies of scale.

The argument of strategic importance and electoral incentives are difficult to dissect, as any decision taken to protect jobs would also be framed in terms of strategic importance, and both arguments are likely at play in any such decision – whether in the Polish insistence on "indigenous production lines" (Kolín 2015, 8), or whether the Swedish government decided to develop the Gripen combat aircraft separately. In any case, these arguments present a strong case for national decision-makers to refrain from pooling defence resources at the European level.

A second argument concerns the divergent levels of threat perception. If a country identifies its main threat to be Russia, for instance, as Poland, Sweden, or the Baltic countries, or as Islamist terrorist groups, as has been the focus of French foreign military policy, requires divergent focus points of military investment and preparation. These divergent threat perceptions are best exemplified within the Visegrad Group, consisting of the Czech Republic, Hungary, Poland and Slovakia. Even though they act as a cohesive bloc on many European policy issues – e.g., migration, rule of law – their perspective of Russia could not be more different, with Poland itching about any rapprochement whereas Hungary and Slovakia had long entertained strong economic and politically friendly relations (Dangerfield 2012; Marton 2012).

In such a context where the Member States cannot be certain that their priorities will be met in a unified European military, the argument of national autonomy weighs even heavier, exacerbating the drive towards the decentral provision of defence. There is evidence that these different threat perceptions lead to different military spending, as well: While Nordic, Central and Eastern European Member States spend more on

traditional, territorial defence against Russia, Southern and Western Member States invest more on projective capabilities such as drones and maritime capabilities (Béraud-Sudreau and Giegerich 2018).

These divergent threat perceptions can undermine trust between the Member States, exemplified by the sluggish response to the Russian military build-up along the Ukrainian border before the invasion. While the Russian territorial aggression against Ukraine in 2014 had led to a streamlining of the perception of Russia as a military threat among the Member States (Béraud-Sudreau and Giegerich 2018), the early reluctance in Berlin and Paris to respond decisively to the military build-up has cost trust from Eastern European partners. This may reinforce the preference of the Baltic countries, Poland, and others to emphasise the provision of mutual security through NATO, fearing that increased military integration in the EU could fasten the withdrawal of the United States as a security actor in the European theatre (Howorth 2018).

Whether NATO and CSDP commitments are actually competing or complementing one another has been the focus of intense academic debate. Principally, the deepening of the EU security architecture has taken into account NATO commitments, granting that commitments to NATO must prevail over EU commitments in case the two are in contradiction (Perot 2019). In the 2000s, it also seemed like a working division of labour developed between NATO – providing hard security and leading military missions – and the EU, which spearheaded humanitarian and crisis response operations through the CSDP (Schleich 2014; Whitman 2004). There has also been plenty of formalised cooperation between the two organisations, culminating in announcing a *strategic partnership* focusing, *inter alia*, on hybrid threats, cyber defence, and some operational cooperation (Tangör 2021).

As such, deeper integration of European militaries must not at all come at a cost of NATO alliance coherence and stability. This is encapsulated in the idea of a "European pillar of NATO" in which the EU would assume more leadership within and also increase their contribution to NATO in the form of a joint EU capability (Domecq 2019; Guéhenno 2017). Such an institutional setup could potentially satisfy calls of the US that the Europeans need to invest more for their own security, while also alleviating concerns by Eastern and Central European Member States that EU military integration could alienate the US (Muti 2021).

However, irrespective of the potential complementarity between the two organisations, at present the ability of NATO to "keep the Americans in" remains the primary objective of the security and defence policy of several Member States (Terlikowski 2022). In this way, a divergent threat perception among the EU Member States also leads to different preferences for answering these threats and provides a strong case against the integration of European armies. Importantly, here not only does the actual complementarity between NATO and the EU's CSDP matter, but that the EU Member States identify this complementarity and feel that integration does not contradict their primary security interests. These concerns may be alleviated by consulting actively with the US, but are unlikely to dissipate in the context of Russian neo-imperialist aggression

and at times slow commitment by large EU Member States – Italy, France, and Germany – to the Western response.

Overall, the arguments for national strategic autonomy, diverse threat perceptions, and the doubt European military integration potentially casts on relations with NATO, demonstrate the heterogeneity of preferences among the EU Member States when it comes to the *how* and *for what* in the provision of military goods, making a strong case for decentralised provision. At the same time, it has been shown that the potential gains through economies of scale are considerable and important. The next section will therefore analyse spill-over effects to determine at which level of government European defence should be provided.

## Spill-over effects: determining the optimal level for the provision of defence

The heterogeneity of preferences, most recently exemplified by divergent assessments of the threat of Russia and the appropriate response to it – even though it later coalesced around a common position – represents a strong argument against the full integration of European militaries. Defence is arguably the most *core* of core state powers, as questions of defence ultimately touch upon the ability of a state to ensure its survival, a state's primordial *raison d'être* in realist visions of international politics, which is the dominant frame of defence policy-making as well as analysis (Genschel and Jachtenfuchs 2016).

As such, the heterogeneity of preferences strongly suggests that European defence may better be provided on a national level through the military alliance envisioned by the Lisbon Treaty. As mentioned above, significant economies of scale could already be achieved by partial military integration, which would reduce duplications and make spending more efficient without fully integrating military forces and administrative structures. As the analysis of spill-over effects shows, however, there are further arguments in favour of a deeper, full integration of EU militaries.

The analysis of spill-over effects seeks to analyse the level of government at which those benefiting from the good – defence production – are congruent with those paying for it. Here, spill-overs may be unevenly distributed in a military alliance. To properly grasp these spill-overs, one needs to take a closer look at the provision of defence in a military alliance. Any one state *I* investing in its defence faces a budget constraint of

$$F^i = y^i + pq^i$$

where F indicates the fiscal space of country *I*, y its non-military spending, p represents a military good and q is the quantity in which the country produces it. If one now takes a look at the provision of deterrence across the multiplicity of Member States, the provision of any individual Member State also includes the provision of defence in another Member State within the military alliance. However, due to preference heterogeneity, this must not be a direct contribution – the other Member States may

produce defence goods that are irrelevant to the threats that any individual Member State faces (Murdoch 1995). The total defence output $Z$ for country $I$ then is

$$Z = pq^{i} + Z^{spill\text{-}over\ i},$$

where $Z^{spill\text{-}over\ i}$ represents the spill-over from other countries' military spending, and the deterrence produced by country $I$ as a function of its military spending times the price per unit of deterrence. With the utility function [ $U^{i} = U^{i}(y^{i}, Z)$ ] and under the budget constraint [ $F^{i} = y^{i} + pq^{i}$ ], country $I$ thus seeks to maximise its utility from both non-military spending and military spending – including the spill-overs from other countries.

The degree of the spill-over country $I$ receives from other countries' military spending may, however, be unevenly distributed. We can identify this in the problem faced by all Member States when trying to maximise their utility from military and non-military spending, under their budget constraints that require a trade-off between spending on y and pq (Murdoch 1995):

$$Max_{y}\, i_{,q}\, i\ \{ U^{i}(y^{i}, f(q^{i}) + Z^{spill\text{-}over\ i} \},$$

where $Z^{spill\text{-}over\ i}$ represents the sum of spill-over of other countries' military spending that spills into country $I$ (Murdoch 1995). It becomes clear from the utility function that the estimation of the spillover plays a central role in any country's policy choices. This is important because it indicates the moral hazard for the Member States to free ride and to focus on the security threats that are most relevant to itself, but not as important for the other Member States. The deterrence against a common threat would be provided by spill-over from other Member States' investments, and the country could maximise its output.

Such incentives can ultimately lead to an underproduction of deterrence. If too many Member States seek to free ride on other Member States' spending on a specific threat, the total amount of deterrence produced may fall below the expected necessary threshold to ensure deterrence due to a lack of coordination. At the same time, uncertainty about the precise amount of deterrence production by another Member State could also lead to the overproduction of a specific deterrence good – inefficient overspending that goes beyond the duplication discussed in the section on economies of scale.

The potential threat of Russia can exemplify this well. Basically, all EU Member States identify Russia as a threat to European security. However, the Baltic countries, Poland, and Finland are the only EU Member States with a direct land border with the Russian Federation. They are thus in a prime position to produce deterrence to this specific potential military threat. Accordingly, Northern and Central and Eastern European Member States invest significantly more to counter this threat in terms of conventional territorial defence (Béraud-Sudreau and Giegerich 2018).

This provides a clear spillover to other EU countries in Southern and Western Europe, as it provides deterrence against a common threat. The expenditures of Southern and

Western European Member States, focusing more on projectable capabilities, do not provide the same spill-over effect for Northern and Eastern European Member States, as these investments are directed towards threats less emphasised by those countries in the North and East of the Union. Apart from the potential for under- and overproduction, this also means that the costs of European defence are unequally shouldered, and Northern and Eastern European countries spend a higher share of GDP (Eurostat 2022) against a common threat.

Based on these elements, fiscal federalism suggests that defence should be organised at the supranational EU level. The integration of EU militaries could mitigate these types of military alliance market failures. The better the cooperation between alliance members, the higher the amount $Z^{\text{spill-over}}$ for any individual country, as uncertainty about other Member States' spending becomes lower and recognition of respective threat perception increases. Full military integration would be the maximum end of this continuum. Rather than potentially unevenly distributed spill-over effects, the defence would be produced and financed jointly, making producers and financers of deterrence production congruent.

In an integrated European military, threat assessment and strategic policy decisions would be taken jointly (Mogherini and Katainen 2017). This would allow the EU to project military power according to its geopolitical potential: Any individual Member State spends less on defence than China, Russia, or Saudi Arabia. Taken together, however, the EU – even without the UK, its previously largest military spender – would rival the military expenditure of China, and reach significantly higher levels than Russia, its closest geopolitical rival (Lye 2020).

This serves as an indicator of the potential geopolitical weight a unified European military would grant the EU – which would ultimately benefit all EU Member States in terms of greater protection and greater influence in the world. However, there is an important corollary to this argument. Even if European militaries were integrated, and hence seized all the available economies of scale, the geopolitical weight and its perception by third countries and systemic rivals depend, crucially, on the EU's credibility to act. This is a crucial point for the integration of European militaries, as the actorness of the European Union in foreign policy and defence matters has often been called into question. Full military integration would at least partially resolve this through common strategic culture. It would lock in cooperation among the EU Member States, create certainty about the intentions and capabilities of other Member States, and would make the respective spill-over effects an integral part of defence assessment.

Such a move to full military integration would, however, require significant political capital. While citizens' attitudes towards deepening defence integration may be stronger than one would assume in areas this close to national sovereignty (Bremer, Genschel, and Jachtenfuchs 2020), such an integrated military would also raise difficult questions, such as the deployment of military forces of any given Member State when military engagement is unpopular with national publics or national governments, or whether the Member States are willing to fully give up on certain defence prerogatives.

From the perspective of fiscal federalism, however, this would be a desirable end state of the current processes of reorganising the EU as a security and defence actor. Importantly, military integration would also respond to many of the identified demand conditions – interoperability, efficient technological innovation and transfer, and the ability to be more self-reliant in defence matters. To ensure fair burden-sharing in defence production and to prevent under- or overproduction of defence, EU militaries should be fully integrated. The decision to which degree these aspects outweigh the heterogeneous preferences among the EU Member States is, ultimately, to be calculated by European and national citizens and parliaments.

## EU Military – a realistic prospect?

The analysis of the integration of EU militaries from the lens of fiscal federalism allows identifying both the potential gains, in terms of operational and spending efficiency, and the important fault lines between the Member States, whose heterogeneous preferences – at least in some Member States – strongly favour a decentralised provision of military power, be it out of security concerns, electoral incentives to protect domestic industry or both. Under these demand conditions, large-scale integration seems unlikely, and military integration will continue to advance slowly and incrementally, mainly through regulatory integration and specific joint projects, for instance through PESCO (Mérand and Angers 2013).

However, the demand conditions are currently shifting considerably in response to the ongoing Russian invasion of Ukraine, which may provide an important impetus for deepening the integration of EU militaries and efforts to strengthen the defence capabilities of the EU. The current war changes the cost-benefit analyses in many EU Member States and will strengthen the already nascent trend toward rising defence budgets. The German announcement to fulfil its two per cent target in the future with a special fund for the *Bundeswehr* attests to the fact that old-standing policy preferences and threat analyses are currently being overhauled. Also at the EU level, the Russian war against Ukraine overhauls long-held *modi operandi*, providing military assistance to Ukraine in a first-ever policy move (De La Baume and Barigazzi 2022).

These examples show that the European security architecture will likely undergo significant reforms in response to the Russian threat in the coming years. The accession of Finland and Sweden into NATO is the clearest example of this, as is the Danish referendum deciding to opt-in EU defence cooperation. The membership of the EU and NATO become more congruent, and NATO becomes "more European than ever" (Szumski and Basso 2022), potentially reducing the costs of cooperation between the two organisations. A "European pillar in NATO" could provide a good frame through which this new constellation of EU defence could be articulated in accordance with NATO.

In this vein, recent developments have also expedited the Strategic Compass, the EU's review of its security and defence policy that was adopted in the wake of the Russian

invasion of Ukraine. The Strategic Compass recognises the potential economies of scale in procurement and R&D, calling for further pooling of research to "jointly develop cutting-edge military capabilities" (European Union 2022, 4). It furthermore envisions the creation of an EU Rapid Deployment Capacity of 5,000 troops and commits to strengthening the command and control structure (European Union 2022). More generally, the Strategic Compass seeks to provide a joint threat assessment and to bring EU action "greater coherence and a common sense of purpose" (European Union 2022, 3), potentially alleviating the fault lines that determine the preference heterogeneity in the Member States.

Overall, the Strategic Compass represents a significant step forward in EU military integration, both on the supply and the demand side of the equation. As such, the Strategic Compass continues the path of gradual deepening in which the Russian challenge to the European security order provides a window of opportunity for acceleration. At the same time, the discordance between the Western European Member States advocating for closer defence cooperation, particularly France and Germany, and the Central and Eastern European Member States indicate that the heterogeneity of preferences has been reinforced, presenting an obstacle to further military integration.

France's and Germany's at times reluctant stance on concerted actions against Russia may lead to a significant loss of trust towards them in Central and Eastern European Member States. Coupled with the central role of the US in supporting Ukraine, Poland, the Baltics and other EU Member States will be extremely hesitant to support any military integration that may reduce the role of the US and increase the profile of France and Germany. Without properly addressing the EU-NATO relationship, Member State preferences will likely remain diverse and complicate the implementation of the Strategic Compass and further integration (Perissich 2021).

As such, the current "window of opportunity" for European defence integration will likely not significantly alter the speed of military integration in the EU. While the crisis of the European security architecture creates political momentum for a deepening of integration, the current crisis also reinforces the role of NATO in European security and in the defence strategies of EU Member States. The continuing inefficiencies in military spending, coupled with the political momentum of the defence dossier, provide incentives for pooling resources, particularly in the fields of procurement and R&D, comparably 'low-hanging fruit' in relation to the potential economies of scale. A holistic reform of EU defence policy towards military integration, however, seems unlikely given the divergence of preferences among the EU Member States.

Such a holistic reform would need to address some other stumbling blocks of integration that the present analysis does not fully account for. These include legal questions of arms exports and the use of force, where domestic regulations and laws would need to be harmonised or competencies conferred to the EU. While such aspects are omitted in the present analysis through the lens of fiscal federalism, they are equally important when it comes to creating a joint operational European military force and to increasing the actorness of the EU in defence policy. As such, they merit further investigation.

## Conclusion

The integration of European militaries could resolve the cooperation problem of European defence in the most cost-effective and efficient way. While heterogeneous preferences weigh particularly heavy on matters such as defence that are closely linked with sovereignty, the present analysis allows making a case for integration. Irrespective of a full pooling of all defence matters, a common procurement market and collaboration in R&D can already significantly increase the efficiency of European military spending, which is currently plagued by duplication and diseconomies of scale. As any Member State's utility function is frustrated by a national budget constraint, standardising procurement and pooling research may already increase spending efficiency and create fiscal space.

There are also relevant arguments that favour decentralisation – currently, EU Member States often assess risks differently, leading to different priorities in defence provision. Mutual trust has taken a hit in the current crisis of the European security architecture provoked by the Russian military attack on Ukraine. While the Russian aggression has likely exacerbated worries in some Member States that further military integration risks rivalling NATO, it also creates the urgency and political space for potentially decisive steps toward military integration. A more efficient and effective EU security and defence architecture could ultimately be beneficial to the trans-Atlantic alliance as a whole. The desire to keep the United States in Europe will remain an important policy driver for many Member States, so coordination with NATO is key for organising any political will for further integration.

Even with an integrated procurement and R&D market, the burden of EU defence would still be shouldered unequally due to the interjurisdictional spill-over of defence production. These spill-over effects indicate that a fully integrated military would provide EU defence in the most efficient way, and would distribute the burden of specific security threats in a fair way. The lens of fiscal federalism strongly suggests *that European defence would be optimally provided at the supranational, EU level*. It becomes clear as well, however, that the degree of integration depends on the positive evaluation by parliaments and governments that more integration actually increases their security. This will only be the case if Member States do not perceive reforms to potentially rival transatlantic security or alienate the US from Europe, and therefore depends centrally on political coordination within and with NATO.

The analysis based on fiscal federalism has also helped to identify the central aspects which still require more research, to better understand the institutional framework in which European military integration can move forward. Most importantly, more research needs to be done on the potential of a European pillar in NATO, and the institutional framework of a European military. For instance, a comparative analysis of national laws regarding the use and deployment of military force could point to the basic tenets of the legal-institutional architecture and identify areas of divergence among the Member States.

In any case, the times when the EU could rely mainly on normative power are over. The Russian war against Ukraine is a watershed moment in the history of Europe, and for its security infrastructure in particular. The lens of fiscal federalism strongly suggests that military integration – with the corresponding economies of scale, rationalisation of redundancies, and a joint strategic culture – could be a central tenet of the EU's security architecture in the future, allowing the EU Member States to shoulder their share of responsibility for European defence jointly and equally.

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