



The G7 Fiscal Trilemma

Entitlements, Defense,
and the Arithmetic of
Insolvency

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EXECUTIVE SUMMARY:

The G7 economies collectively face a fiscal trilemma that has no painless resolution. The three vertices of this trilemma are: (1) honoring existing social entitlements for rapidly ageing populations; (2) meeting dramatically higher defense spending commitments under NATO's new 5% of GDP target; and (3) maintaining sovereign debt sustainability in a higher-rate environment. The arithmetic, as this paper demonstrates, does not work without significant policy trade-offs.

Six of the seven G7 nations now exceed or approach a 100% gross debt-to-GDP ratio. Only Germany retains meaningful fiscal headroom, and even Berlin has amended its constitution to borrow more for defense. Age-related spending pressures, while partially mitigated in Europe by three decades of pension reform, remain acute in the United States and Japan. On top of this baseline, NATO's June 2025 Hague Summit commitment to 5% of GDP in defense and security spending by 2035 represents a fiscal step-change that most member nations have no credible plan to fund.

The total additional fiscal burden across these three vectors ranges from approximately 3 to 5 percentage points of GDP for most G7 European members, layered onto already-strained budgets. The resolution will almost certainly involve some combination of entitlement reform, higher taxation, financial repression, and/or structurally elevated inflation. Each pathway carries distinct implications for asset allocation and the relative attractiveness of real assets, alternatives, and inflation-hedged strategies.

THE G7 FISCAL LANDSCAPE:

The fiscal positions of G7 nations have deteriorated markedly since the Global Financial Crisis, with the COVID-19 pandemic and subsequent policy responses driving a further structural widening. While nominal deficits have narrowed from their 2020 peaks, most G7 economies remain well above pre-pandemic deficit levels and show limited appetite for consolidation.

Table 1: G7 Fiscal Snapshot (2024-2025 estimates)

Country	Govt Spend (% GDP)	Revenue (% GDP)	Deficit (% GDP)	Gross Debt (% GDP)	Tax/GDP Ratio	Defense (% GDP)
United States	~38%	~30%	-6.5%	~124%	~27%	~3.4%
Japan	~44%	~38%	-5.5%	~230%	~34%	~1.6%
France	~57%	~51%	-5.8%	~112%	~45%	~2.1%
Italy	~50%	~47%	-3.5%	~137%	~43%	~1.5%
United Kingdom	~45%	~40%	-4.5%	~104%	~35%	~2.3%
Germany	~49%	~46%	-2.5%	~63%	~42%	~2.1%
Canada	~43%	~41%	-1.5%	~107%	~34%	~2.0%

Sources: IMF World Economic Outlook (October 2025); OECD Revenue Statistics 2025; NATO Defense Expenditures (2024). Figures are approximate, based on general government definitions.

Several features of this table merit attention. The United States combines the lowest revenue base of any G7 nation (approximately 30% of GDP) with its largest structural deficit. France, by contrast, extracts the highest share of GDP in revenue (approximately 51%) yet still runs a deficit approaching 6% of GDP owing to commensurately high expenditures. Only Germany operates with a deficit narrow enough to stabilize its debt ratio, and its debt-to-GDP of approximately 63% stands as the sole G7 member below the 100% threshold.

The IMF projects the United States will see the greatest accumulation in gross government debt of any G7 nation through the end of the decade, with debt-to-GDP potentially reaching 128% by 2030. Japan's position at 230% of GDP is *sui generis*,



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sustained primarily by domestic ownership of government debt and decades of near-zero interest rates, but increasingly vulnerable as the Bank of Japan normalizes monetary policy.

THE DEMOGRAPHIC PRESSURE:

Population ageing represents the most predictable and least contested fiscal challenge facing the G7. The trajectory of old-age dependency ratios is determined by fertility rates set decades ago and mortality improvements already in motion. What varies across the G7 is the degree to which governments have reformed their entitlement structures to accommodate this inevitability.

The European Story: Reform, but Not Immunity: The European Commission's 2024 Ageing Report projects total age-related public expenditure across the EU rising by only 1.2 percentage points of GDP between 2022 and 2070. This relatively benign aggregate figure reflects three decades of pension reform: increases to statutory retirement ages, reductions in replacement rates (projected to fall from 45% to 38% on average by 2070), and shifts toward funded or notional defined-contribution schemes.

However, this aggregate masks significant variation. Spain is a notable outlier, with pension spending projected to rise from 13.1% to 16.7% of GDP by 2070 absent further reform. Germany faces moderate pressure, with age-related costs increasing by up to 3 percentage points of GDP. The contribution of labor to GDP growth is expected to turn negative in the EU as of the late 2020s, shrinking the denominator against which all fiscal ratios are measured.

6 of 7 G7 Nations at or Above 100% Debt-to-GDP

Only Germany retains meaningful fiscal headroom at 63%. The U.S. is projected to reach 128% by 2030; Japan stands alone at 230%.

Critically, the EU baseline projections assume no new entitlements and depend on replacement rate declines that may prove politically fragile. An ageing electorate with growing voting power may resist further erosion of pension generosity, creating a ratchet effect on spending commitments.

The Anglosphere and Japan – Larger Gaps: The United States and Japan face substantially steeper age-related fiscal trajectories than their European counterparts. The U.S. Congressional Budget Office estimates that federal healthcare and pension expenditures will rise by 4 to 5 percentage points of GDP between 2025 and 2055, a figure that dwarfs the European projection. The combination of Medicare, Medicaid, and Social Security obligations, compounded by healthcare cost inflation that chronically outstrips general inflation, produces a structural spending trajectory that current policy frameworks cannot absorb.

Japan's demographic crisis is the G7's most acute. With a median age approaching 49 and a fertility rate well below replacement, the ratio of workers to retirees continues to compress. Japan has maintained fiscal stability through domestic absorption of government debt and ultra-loose monetary policy, but the Bank of Japan's tentative steps toward normalization introduce a new variable: the sensitivity of debt service costs to even modest rate increases on a 230% debt stock.

Canada and the United Kingdom occupy intermediate positions. Canada has very high immigration flows, which partially offset natural population ageing, but its social entitlements programs, particularly its provincial healthcare systems face growing cost pressure. The UK's National Health Service is experiencing chronic capacity constraints, with health spending as a share of GDP trending upward despite periodic fiscal consolidation efforts.

THE NATO 5% COMMITMENT:

The June 2025 NATO Summit in The Hague produced the most significant upward revision to Alliance spending expectations since the founding of the organization. All 32 member states, with the exception of Spain which received an exemption, committed to raising annual defense and security-related expenditures to 5% of GDP by 2035.

Structure of the 5% Target: The commitment is divided into two components: 3.5% of GDP for core defense spending (the figure directly comparable to the previous 2% guideline), and up to 1.5% of GDP for ancillary defense and security-related spending including cyber-defense, supply chain resilience, critical infrastructure protection, defense innovation, and civil preparedness. National implementation roadmaps were required by mid-2026, with a collective progress review scheduled for 2029.

Context is important. European NATO members averaged approximately 1.5% of GDP on defense in the decade preceding Russia’s invasion of Ukraine in 2022, rising to roughly 2.0% by 2024. Meeting the 3.5% core target therefore requires most European members to nearly double their current defense budgets, a fiscal undertaking without precedent in the post-Cold War era. The last time the United States itself spent 5% of GDP on defense was during the final years of the Cold War and the first Gulf War.

Country-Specific Fiscal Impacts:

Table 2: Illustrative Fiscal Impact of NATO 5% Target				
Country	Current Defense Spend (% GDP)	Gap to 3.5% Core Target	Est. Additional Annual Cost	Key Constraint
United States	~3.4%	~0.1%	~US\$30B	Political will; deficit trajectory
Japan	~1.6%	~1.9%	~US\$95B	Constitutional constraints; debt burden
France	~2.1%	~1.4%	~EUR 40B	Deficit already ~6%; ratings pressure
Italy	~1.5%	~2.0%	~EUR 45B	Debt at 137%; EU fiscal rules
United Kingdom	~2.3%	~1.2%	~GBP 40B	Austerity fatigue; NHS demands
Germany	~2.1%	~1.4%	~EUR 60B	Debt brake amended; supply-side limits
Canada	~2.0%	~1.5%	~CAD 50B	PBO projects +1.4pp deficit by 2035

Sources: NATO Defense Expenditures (2024); Canada PBO (February 2026); ABN AMRO Research; CaixaBank Research. Estimates are illustrative, based on current GDP levels and linear scaling.

Germany has emerged as the most credible commitment case. Berlin has announced plans to raise its core defense budget from EUR 86 billion to EUR 153 billion by 2029, enabled by a constitutional amendment to the debt brake. This projected increase alone exceeds the combined 2024 defense spending of all Bucharest Nine countries on NATO’s eastern flank.

Canada’s Parliamentary Budget Officer, in an analysis published in February 2026, estimated that reaching the 5% target through gradual increases in core defense spending from 2.0% to 3.5% of GDP by 2035 would require additional spending averaging approximately CAD 33.5 billion per year over the next decade. The cumulative impact would increase the federal deficit by CAD 63 billion (1.4 percentage points of GDP) and the federal debt-to-GDP ratio by 6.3 percentage points by 2035-36.

Spain’s outright rejection of the target, capping its commitment at 2.1% of GDP, highlights the political fragility of the agreement. Prime Minister Sánchez described the 5% target as “unreasonable and counterproductive,” citing competing fiscal and social spending priorities. This dissent, combined with the absence of enforcement mechanisms, raises questions about the credibility of the headline commitment for other fiscally constrained members including France and Italy, neither of which has requested activation of the EU’s national escape clause for defense spending.

NATO 5%: Doubling European Defense Budgets in a Decade

European NATO members spent ~1.5% of GDP on defense before 2022. The new 3.5% core target requires most to nearly double their budgets—without precedent in the post-Cold War era.

THE IMPOSSIBLE ARITHMETIC:

The central argument of this paper is that the G7 collectively faces a fiscal trilemma: it is not possible to simultaneously maintain current social entitlement trajectories, meet dramatically higher defense commitments, and preserve sovereign debt sustainability. At least one goal must give.

Stacking the Burdens: For a representative G7 European member, the cumulative additional fiscal burden over the coming decade can be approximated as follows:

Table 3: Additional Budget Burden Forecast

Fiscal Vector	Additional Burden (pp of GDP)	Time Horizon
Ageing-related spending increase	+1.0 to +3.0	Through 2050-2070
Defense increase to 3.5% core target	+1.0 to +2.0	By 2035
Rising debt service costs (rate normalization)	+0.5 to +1.5	Through 2030
Total incremental fiscal pressure	+2.5 to +6.5	Cumulative

Source: Omnigence analysis based on EU 2024 Ageing Report, NATO commitments, IMF Fiscal Monitor (April 2025).

These figures represent a lower bound for the United States, where age-related spending growth alone is projected at 4 to 5 percentage points of GDP, and where net interest expense is projected to remain at approximately 3.8% of GDP through the end of the decade, up from roughly 1.5% a decade ago.

The Tax Ceiling: One natural response to the trilemma is to raise revenues. The OECD average tax-to-GDP ratio reached 34.1% in 2024, the highest level ever recorded across the 38-member organization. But the capacity to raise additional revenue varies enormously across the G7:

France, at ~45% tax-to-GDP, operates near the practical ceiling observed in advanced economies. Denmark, at ~46%, represents the highest sustained tax burden among OECD members. There is limited empirical evidence that tax-to-GDP ratios can be durably sustained above 50% without significant economic distortion. The United States, at approximately 27%, has the most theoretical headroom but is moving in the opposite direction: the One Big Beautiful Bill Act signed in 2025 reduced revenues substantially, and the political environment in Washington remains hostile to tax increases.

The IMF’s own research on fiscal consolidation in advanced economies has found that consolidation efforts often have a negligible effect on debt ratios precisely because the consolidation itself suppresses growth, eroding the GDP denominator. This creates a circular trap: raising taxes to close deficits reduces growth, which widens deficits relative to shrinking GDP, necessitating further tax increases. The multiplier effects are particularly adverse when consolidation is concentrated on the revenue side rather than the expenditure side.

The Debt Sustainability Question: The IMF’s April 2025 Fiscal Monitor warned that an increase of 10 percentage points in U.S. public debt between 2024 and 2029 could lead to a 60-basis-point rise in long-term interest rates. Similar dynamics apply across the G7, where long-term rates have risen even as central banks have reduced policy rates, reflecting investor concern about fiscal sustainability and term premium recompression.

The ratings environment is tightening. Moody’s downgraded the United States in 2025 over debt concerns. Two of three major agencies have assigned a negative outlook to France. The IMF has urged Italy to undertake fiscal reform. Against this backdrop, the prospect of G7 nations collectively issuing trillions of dollars in additional sovereign debt to finance both entitlements and defense is likely to encounter rising market resistance in the form of higher term premia, steeper yield curves, and potential ratings downgrades.

RESOLUTION PATHWAYS AND THEIR CONSEQUENCES:

If the arithmetic does not work without adjustment, the question becomes which adjustments are politically feasible and what their economic consequences will be. We identify four primary resolution pathways, none of which is mutually exclusive.

Entitlement Reform: The OECD estimates that linking retirement ages to two-thirds of projected gains in life expectancy, combined with labor market reforms to increase participation, could lower fiscal pressure by approximately 4 percentage points of GDP by 2060 for the average OECD country. This would substantially close the gap. However, such reforms are politically toxic in ageing societies where retirees constitute a growing share of the electorate. France’s experience with pension reform protests illustrates the resistance. Reform is most likely to occur incrementally and under fiscal duress, rather than proactively.

Higher Taxation: As discussed, the scope for additional revenue varies by country but is constrained everywhere by the strong growth-dampening effects of higher tax burdens. Countries already operating above 40% tax-to-GDP have limited headroom. The United States has the most room but the least political inclination. The most likely revenue-side adjustments involve

broadening bases (reducing exemptions and deductions) rather than raising headline rates, alongside continued expansion of value-added and consumption taxes in jurisdictions that rely heavily on income taxation.

Financial Repression: Financial repression, defined as the use of regulatory and monetary tools to channel savings into government debt at below-market rates, represents the path of least political resistance. This can take the form of central bank yield curve control (as practiced by Japan), regulatory requirements for financial institutions to hold government bonds, or the maintenance of negative real interest rates over extended periods. The practical effect is a wealth transfer from savers and bondholders to sovereign debtors, a form of stealth taxation that avoids the legislative process.

Structural Inflation: The final resolution pathway is to permit, or even encourage, a sustained period of above-target inflation to erode the real value of nominal debt obligations. This is the least transparent pathway but arguably the most historically

common resolution to excessive sovereign indebtedness. The combination of defense spending (inherently demand-side stimulus with limited productivity offset), shrinking labor forces, and fiscal deficits creates a structurally inflationary mix. If central banks accommodate this dynamic, whether by choice or political compulsion, the result is a gradual reduction in the real burden of debt.

OECD Tax Revenues Hit All-Time High at 34.1% of GDP

Denmark leads at 45.2%, France at 43.5%. The U.S. at 25.6% has theoretical headroom but is cutting revenues. Limited evidence suggests ratios above 50% are sustainable.

In practice, the resolution for most G7 nations will involve all four pathways simultaneously: modest entitlement reform, incremental tax increases, regulatory direction of capital flows, and toleration of

above-target inflation. The mix will vary by country, with Germany likely to lean most on taxation and reform, Japan on financial repression, and the United States on deficit spending and inflation toleration. Classic raw material for a period of mild stagflation.

INVESTMENT IMPLICATIONS:

The fiscal trilemma outlined above is not a hypothetical future risk; it is the operating environment for the next decade and beyond. Each resolution pathway carries distinct implications for asset allocation.

Real Assets as Structural Beneficiaries: In a world where the probable resolution involves some combination of financial repression and above-target inflation, assets with intrinsic real value and inflation-linked cash flows become structurally attractive. Farmland, in particular, benefits from multiple tailwinds in this environment: its cash flows (crop revenues) adjust with commodity prices, its capital value has historically exhibited low correlation with traditional financial assets, and it benefits from the same demographic pressure (growing global population requiring more food) that is straining fiscal budgets on the entitlement side.

Duration Risk in Fixed Income: Sovereign bond portfolios face an adverse combination of rising supply (to fund defense and entitlements), potential ratings deterioration, and inflation erosion. The steepening of yield curves observed across G7 nations since 2022 is likely to persist. Investors with long-duration fixed income exposure should consider the term premium implications of structurally higher issuance. Private credit, while offering yield premium, faces its own challenges as evidenced by recent stress in the sector – other forms of yielding alternative assets may need to replace its role in alternative allocations.

3–5pp of GDP: The Cumulative Burden Ahead

Age-related spending, defense commitments, and rising debt service stack to 3–5 percentage points of additional fiscal burden per G7 member over the coming decade. For the U.S., even more.

Defense as an Investment Theme: The NATO 5% commitment, even if partially fulfilled, represents a multi-decade structural increase in government procurement. European defense spending is expected to rise from 1.8% of GDP in 2024 to 2.5% by 2026, with further increases thereafter. This creates investable themes in defense manufacturing, cybersecurity, critical infrastructure, and the supporting industrial ecosystem.

CONCLUSION:

The G7 fiscal trilemma is not a crisis of the future; it is a condition of the present. The commitments have been made, the demographics are locked in, and the debt has been accumulated. What remains is the question of how the adjustment will be distributed: across generations, between savers and borrowers, between taxpayers and beneficiaries, and between domestic populations and foreign creditors.

History suggests that the adjustment will be managed rather than resolved, spread across multiple pathways over an extended period, and ultimately borne disproportionately by holders of nominal financial assets. For institutional investors, the implication is that the traditional 60/40 portfolio allocation to government bonds carries embedded fiscal risk that has not been fully priced. Real assets, alternatives with inflation-linked characteristics, and strategies that benefit from financial repression and fiscal dominance warrant structural overweights in this environment.

The question is not whether the G7 will meet its combined obligations in full. It will not. The question is which obligations will be diluted, and through which mechanisms. The answer to that question will define the investment landscape for the next decade.

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