Defence spending in the EU: between opportunity and fiscal dilemma

The recent increase in defence spending opens a new chapter for the European economy: it can boost activity in the short term and strengthen the industrial base if managed well, but its true effect will depend on how it is financed, organised and translated into productive capacity. This article examines that balance between opportunity and fiscal dilemma.

Concepción Sanz Gómez

Europe enters a new cycle of defence spending

The war in Ukraine and geopolitical changes have led European countries to commit to a historic increase in their defence and security capabilities. In 2025, European Union (EU) countries spent 418 billion euros on defence, 80% more than before the war in Ukraine began. That spending corresponded to 2.2% of gross domestic product (GDP), compared with 1.5% recorded in 2021. All signs point to this trend continuing in 2026, when defence spending could rise to 454 billion euros, equivalent to 2.4% of GDP[1].

This trajectory will need to continue if the North Atlantic Treaty Organization (NATO) targets agreed at the June 2025 Hague Summit are to be met. Twenty-three of the EU's 27 member states belong to that organisation. The targets consist of raising military capability spending to 3.5% of GDP and dedicating an additional 1.5% to defence- and security-related investments (in, inter alia, critical infrastructure, resilience, innovation, the industrial base), to amount to a total of 5% of GDP. That figure is more than double current defence spending and is comparable to United States expenditure during the Cold War.

Europe's defence buildup will reshape fiscal priorities and economic dynamics

An increase of this magnitude implies a profound shift in fiscal priorities that will have a substantial impact on the economy, with effects that could be mixed. On the one hand, the increase will stimulate economic activity because it will produce an expansionary demand shock, especially in defence-related sectors. On the other, it could put pressure on inflation and pose serious challenges for public finances, since many countries are coming to this policy with high public debt levels and limited fiscal space.

Short-term macroeconomic impact

Empirical evidence shows that increases in defence spending usually have a positive impact on GDP in the short term, although the multiplier effect tends to be somewhat below one. In other words, for every additional euro spent on defence, economic activity rises by a slightly smaller amount[2]. Even so, there is considerable dispersion among the different estimates because the impact depends on factors that can vary

[1] European Defence Agency (2026), 'Defence Data 2025–2026', Brussels.
[2] Bokan, N., Jacquinot, P., Lalik, M., Müller, G., Priftis, R., and Rigato, R. (2025), 'Macroeconomic impacts of higher defence spending: A model-based assessment', ECB Economic Bulletin, 6/2025, European Central Bank.

widely across countries or over time, such as how the spending is financed, the type of defence goods purchased and each economy's propensity to import, its position in the cycle, or its initial fiscal situation.

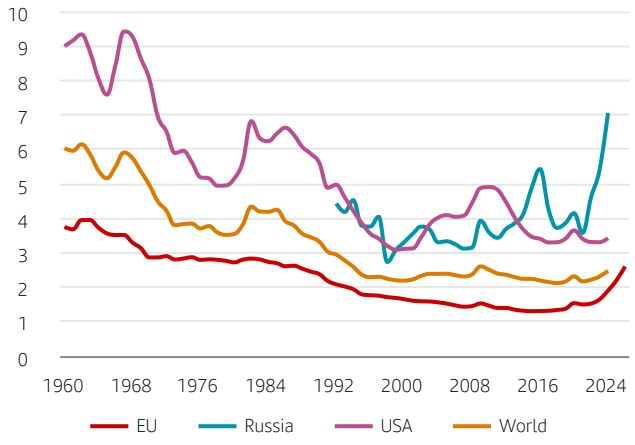
Higher defence spending supports GDP growth, while its impact on inflation appears relatively modest

For the euro area, the European Central Bank (ECB) assessed the likely impact of the defence-spending measures announced in 2025 in order to incorporate them into its economic projections for the 2025–2027 period. Its conclusion was that the impact on economic activity would be consistent with a multiplier close to one[3], in line with the empirical consensus. Specifically, for a defence-spending expansion equivalent to 0.4% of GDP over the three years of its projection horizon[4], the cumulative increase in euro-area GDP would be 0.3%.

In inflation terms, the ECB's work offers a relatively reassuring picture. Based on simulations using different economic models, it concluded that a gradual increase in spending equivalent to 1% of GDP would raise inflation by only 0.07 percentage points after two years and by approximately 0.2 points after four years. The reason these effects are so modest is that much of military spending does not enter the consumer price index basket directly, and inflationary effects appear indirectly, through stronger domestic demand, wage pressures or higher production costs.

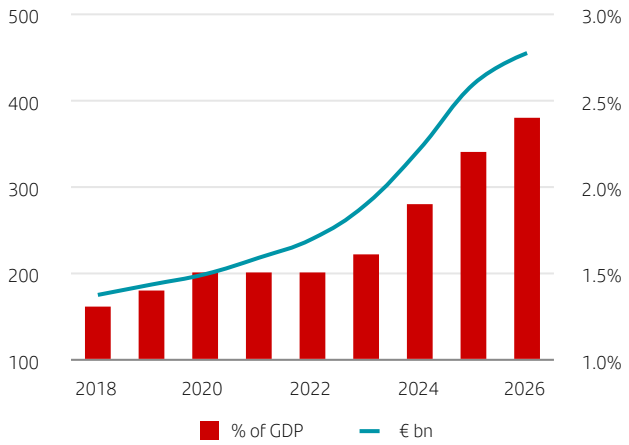
By contrast, the International Monetary Fund (IMF) has found evidence of stronger impacts on the economic growth of EU countries. In a study covering the period 1989–2023[5], it estimated that a steady increase in defence spending equal to 1% of GDP could lead to a 1.3% increase in GDP in the same year as the demand shock and nearly 2% two years later. Moreover, when spending is concentrated in investment, multipliers are higher, especially in the case of equipment purchases, the impact of which on GDP can be as much as three times greater than the amount spent.

Military spending
(% of GDP)



Sources: World Bank and European Defence Agency.

EU defence expenditure
(€bn and % of GDP)



Source: European Defence Agency.

[3] Checherita-Westphal, C., Huber, C., Rodríguez-Vives, M., and Müller, G. (2025), 'Fiscal aspects of European defence spending: Implications for euro area macroeconomic projections and associated risks', ECB Economic Bulletin, 5/2025, European Central Bank.
[4] Excluding 0.2% of GDP for support to Ukraine's defence, since the ECB assumes it has no direct macroeconomic impact on the euro area.
[5] Furceri, D., Juarros, P., Mishra, S., Anh Dinh Minh Nguyen, A. S., Pessoa, A. S., and Sollaci, A. (2026), 'Macroeconomic impacts of EU defense spending', IMF Working Paper, 26/53, Washington, DC.

The ultimate economic impact will be determined by how rearmament is financed and implemented

However, these figures should be interpreted with caution. The IMF itself notes that the rearmament process now being considered in Europe will be faster, more synchronised and larger in scale than those of the sample used for its estimates. Under current conditions, the impact on inflation could be greater given the size of the demand impulse. If that turns out to be the case, monetary policy could respond more strictly than in recent years, with interest-rate hikes that would ultimately crowd out private investment. As a result, defence-spending multipliers would be smaller than the initial estimates suggest.

Although the two studies are not fully comparable because one uses a model-simulation approach (the ECB) and the other an estimate based on a country sample over a period of time (the IMF), both conclude that defence spending can indeed boost activity in the short term, but the magnitude of that boost is decided by other factors, including the specific design of the fiscal expansion.

Long-term effects

The long-term benefits will depend on the ability to generate innovation and productivity gains

In the long run, the evidence is less conclusive. The IMF study mentioned above found that capital stock increased as a result of higher defence investment, but that the positive productivity effects disappeared once the cyclical component was removed. In other words: defence spending can help in the short term, but it does not by itself guarantee lasting productivity gains. Those gains could emerge if a significant share of spending is directed towards research and development (R&D), innovation and technologies with spillover effects on the private sector. But there is also the opposite risk: that resources are allocated inefficiently, diverting them away from the private sector or from other public goods that could have generated greater welfare[6].

Given the interest shown by the European Commission and several governments in ramping up military and security capabilities in the EU, even relatively modest multipliers suggest that EU economic growth in the coming years could be above the annual average recorded since the pandemic (which has been a meagre 1%). But that does not mean the impact will be stable, homogeneous or necessarily durable. Fiscal and industrial heterogeneity across countries can make the effects very different.

The financing challenge

Higher defence spending will test the fiscal resilience of many European economies

The first factor that determines the extent to which activity is boosted is how the spending is financed. Defence-spending expansions usually have a stronger impact on growth in the short term when financed with debt, because they raise the deficit and sustain aggregate demand. Later on, however, offsetting effects tend to appear. To finance permanent spending increases, governments consider raising taxes or cutting other spending items. The private sector may also brace for deficit-corrective measures that reduce disposable income. Investors too may become more concerned about the sustainability of public finances. All of this eventually puts upward pressure on interest rates and reduces private consumption and investment.

[6] Ilzetzki, E. (2025), 'Guns and growth: The economic consequences of defense buildups', Kiel Report No. 2, Kiel Institute for the World Economy.

A key point is that this economic boost entails risks for public finances. In many EU countries, the increase in defence spending comes in a context of already soaring public debt, interest rates higher than in the previous decade and less fiscal room to absorb new spending pressures. This means that financing defence spending with debt could, in the medium term, put pressure on the risk premium, the cost of financing and the fiscal space available for other public priorities.

In many EU countries, higher defence spending comes amid high public debt and limited fiscal space

This pattern is likely to be observed in EU countries' current rearmament cycle: first there'll be a more expansionary period and then an adjustment phase. The European Commission has given member states the option of requesting activation of the national escape clause in the fiscal rules, making it easier to temporarily raise defence spending without requiring immediate cuts to other items or tax increases. However, this solution is temporary; it expires in 2028. After that, countries will have to accommodate higher defence spending, either by restructuring other spending, improving public-spending efficiency or increasing tax revenue.

In countries with less fiscal space, the dilemma can be especially acute. So far, 18 of the EU's 27 countries have taken advantage of this flexibility[7]. Those that have not include France and Italy, two of the most indebted countries in the EU that are also among those facing the highest financing costs. These two countries, however, have requested funding through the Security Action of Europe (SAFE) instrument, which consists of long-term loans granted by the EU for joint procurement. The advantage for countries with little fiscal space is a lower financing cost than if they were to use national debt, since this instrument is backed by EU bond issuances. The fact that France and Italy have requested this funding suggests that both countries have an appetite to undertake defence projects, but financing conditions are a major constraint.

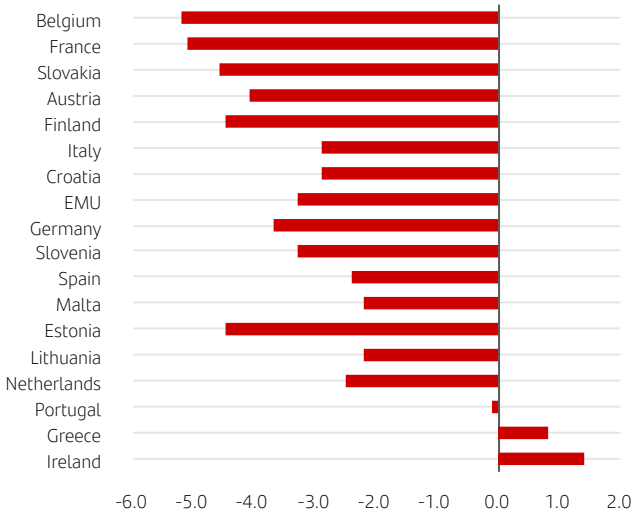
Fiscal constraints vary widely across Europe, shaping countries' ability to rearm

In short, fiscal space in Europe is not homogeneous across all countries. For that reason, having adequate financing instruments and complementing them with public-private collaboration can be essential to address the financial constraints faced by some countries. The tools made available by the Commission, such as the escape clause or SAFE loans, can be helpful, but they still count as national public debt, which may limit their use in countries with high debt.

In this context, common European financing could provide a response with greater reach. The 2028–2034 Multiannual Financial Framework could strengthen EU-level support for defence investment, with the European Commission proposing a significant expansion of funding for defence, security and space. While this would not finance member states' ordinary military expenditure, it could support common European capabilities and reduce pressure on national budgets. However, the final scale and design remain subject to negotiation.

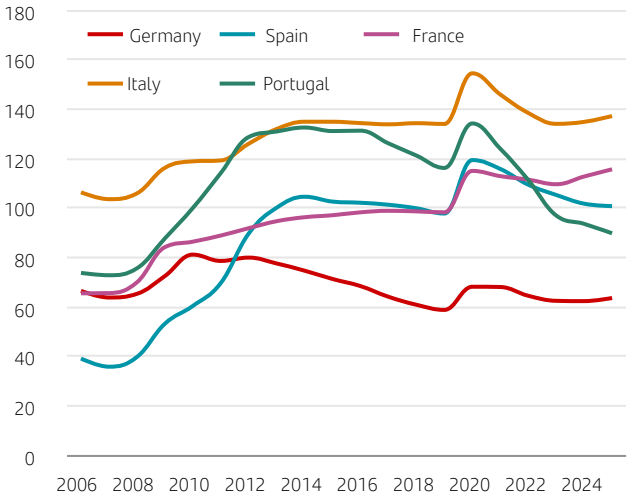
[7] Those countries are: Austria, Belgium, Bulgaria, Croatia, the Czech Republic, Denmark, Estonia, Finland, Germany, Greece, Hungary, Latvia, Lithuania, Poland, Portugal, Slovakia, Slovenia and Spain.

Public deficit in EU countries in 2025
(% of GDP)



Source: Eurostat.

Public debt in selected EU countries
(% of GDP)



Source: Eurostat.

The composition of spending also matters

The second deciding factor is the composition of spending. Not all military spending has the same economic effect. Spending directed towards investment, equipment and innovation usually has a larger and more lasting impact than spending on items such as personnel, maintenance or routine purchases[8].

This point may work in the EU's favour because the current priority is to strengthen military and technological capabilities. For that reason, the weight of investment within total spending has increased: it went from 20% in 2020 to 32% in the latest year, and could reach 36% in 2026.

The composition of defence spending matters as much as its scale

However, that rise in investment is explained mainly by the push from equipment purchases. R&D spending[9], which is the component most clearly able to foster innovation and generate more lasting effects, has grown but is still lagging. According to the European Defence Agency (EDA)[10], R&D is still concentrated in a small number of countries, and it would be desirable to strengthen links between civilian and defence innovation ecosystems so that new technologies can spread more effectively and have positive long-term effects.

Europe's industrial capacity

Third, the impact on economic activity will be greater the more it is covered by purchases within the EU. When the stimulus is partly directed towards importing goods from abroad, increases in domestic production are obviously smaller, and the external position deteriorates. Therefore, if Europe's supply capacity can respond quickly, higher

[8] International Monetary Fund (2026), 'World Economic Outlook: Global Economy in the Shadow of War', chapter 'Defense spending: Macroeconomic consequences and trade-offs', Washington, DC.
[9] Draghi, M. (September 2024), 'The future of European competitiveness', European Commission.
[10] European Defence Agency (EDA, 2026).

spending can be prevented from turning into more imports, bottlenecks and price pressures.

Fragmentation and external dependence may limit the economic dividend from rearmament

For that reason, the defence industrial base is a critical element. Today, the EU defence industry is fragmented, as it is organised around national markets. That fragmentation makes it harder to exploit economies of scale and often reinforces dependence on imports. The figure commonly used to illustrate this comes from the Draghi report, which states that nearly 80% of procurement carried out by states between June 2022 and June 2023 was from suppliers outside the EU, especially from the United States. Similarly, the European Commission has indicated that arms imports by European NATO members between 2020 and 2024 more than doubled relative to the previous five years, and the share coming from the United States rose from 52% to 64%[11].

More coordination, greater economic impact

European coordination can improve the economic impact of defence spending. Joint procurement and less fragmented public contracting appear to be essential conditions for increasing spending efficiency, promoting economies of scale and reducing leakage into imports. In that vein, the EU announced in March 2025 the European Defence Industrial Strategy (EDIS) and the European Defence Industry Programme (EDIP). Both instruments seek to boost joint procurement within the EU, expand Europe's defence industrial and technological base and improve resilience in supply chains.

Conclusion

Defence buildup can support growth, but lasting gains depend on turning spending into economic capacity

The increase in defence spending can have positive effects on short-term economic growth by acting as a demand stimulus at a time when the EU is in a weak cyclical position, operating below capacity.

However, for that effect to consolidate and translate into more lasting benefits, several additional conditions are needed: sustainable financing, sufficient European production capacity, effective coordination among member states and a rapid expansion of supply that makes it possible to absorb rising demand without generating bottlenecks. If such conditions do not materialise, the result would be much more limited, weakened by leakage into imports, higher inflationary pressure, more uncertainty around public debt and greater strain on other budgetary priorities.

[11] European Commission (May 2025), 'Spring 2025 Economic Forecast: Moderate Growth amid Global Economic Uncertainty', chapter 'The economic impact of higher defence spending'.