ANALYSIS

How would higher defence spending affect Finland's economic growth?

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Along with many other European countries, Finland intends to increase its defence spending in the coming years. Higher defence spending would have a significant impact on the national economy, as it would increase public spending and affect both domestic and international demand. This article examines how such an increase in defence spending would affect economic growth and inflation in Finland in the period 2026–2029. The analysis is based on results from the Bank of Finland's Aino model and simulations made using the so-called basic model elasticities (BME) for the euro area.

Europe aims to strengthen its defence capabilities

Growing geopolitical tensions have created a need to strengthen Europe's defence capabilities. Some countries have already announced significant increases in defence spending. In March 2025, the European Commission presented the Readiness 2030 plan, the purpose of which is to support the European defence industry, deepen the single defence market, and facilitate the ramping up of defence spending through a new financial instrument and with additional flexibility in the fiscal rules.

NATO's target for defence spending by its member countries as a share of national gross domestic product (GDP) is set to rise beyond 2% in the coming years. In the present discussions, a new 3%–3.5% target level has been suggested, and possibly even a 5% longer-term target with a broader definition.[1] Decisions are expected to be made at the NATO summit in late June 2025. The increase in defence spending will, in any case, be considerable, reflecting countries' aspirations to strengthen their defences in a transformed geopolitical environment. Higher spending on defence is an important strategic decision that can have a significant impact on economic conditions and on the foreign and security policy environment.

This article reports on two simulations of the national economic impact of higher defence spending by Finland and within the euro area during 2026–2029.

Defence spending in Finland and the euro area

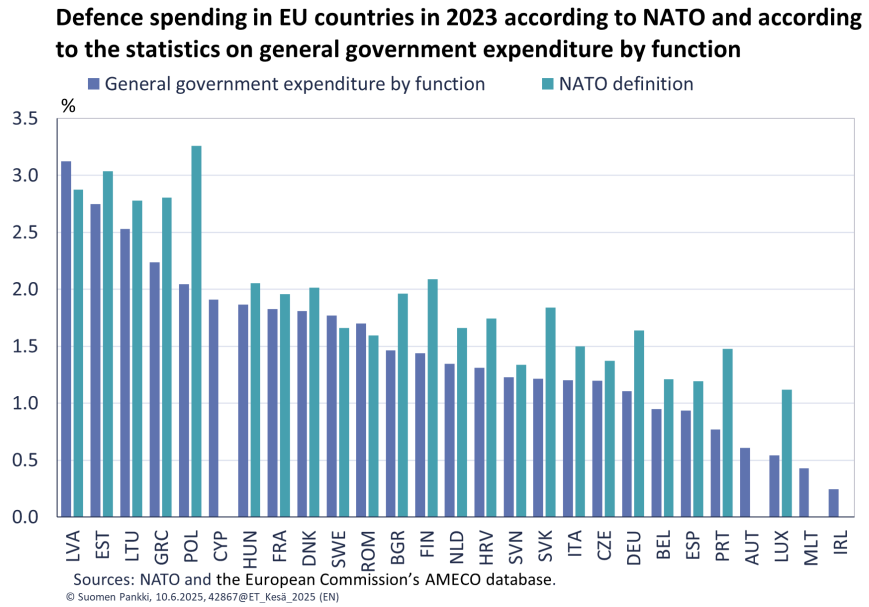
Various definitions of defence spending are in use. Using the definition determined by NATO, Finland's defence spending as a share of GDP has grown from 1.4% in 2021 to 2.1% in 2023, and further to 2.4% in 2024. However, according to the Statistics Finland data on general government expenditure by function, defence spending was just 1.4% of GDP in 2023.[2] On the basis of the NATO definition, defence spending by NATO

1. Situation on 2 June 2025.

member countries that are also members of the euro area[3] was 1.6% in 2023 and 1.9% in 2024 in total. According to the statistics on general government expenditure by function, defence spending in the entire euro area was 1.2% of GDP in 2023 (Chart 1).

To a large extent, the increase in Finland's defence spending is attributable to the fighter aircraft procurement for the Finnish Air Force and the Finnish Navy's corvette procurement. The fighter aircraft procurement is currently costing approximately EUR 1.5 billion annually, but in the final years 2029 and 2030, this will decline to an annual EUR 400 million.

Chart 1.



The Finnish Government has proposed raising defence spending to at least 3% of GDP by 2029. In the General Government Fiscal Plan for 2026–2029, the most significant increases in defence spending are planned for the first half of the next parliamentary term in 2028–2029. During these years, the appropriations for the Ministry of Defence and its ministerial sector are expected to grow by 14% in real terms, i.e. by approximately EUR 1 billion in both 2028 and 2029.[4]

2. The expenditure of the Finnish Defence Forces (incl. pension expenditure) included in the NATO definition is entered on a cash basis, whereas in the National Accounts and in the statistics on general government expenditure by function, defence spending is entered on an accruals basis and pension expenditure is not included. There are also other differences in the comprehensiveness of the data. The statistics on general government expenditure by function are based on the COFOG classification (classification of the functions of government). In the case of Finland, the difference between the cash basis and accruals basis is important for the way the F-35 fighter aircraft procurements are entered in the statistics. The statistics on general government expenditure by function currently only extend to 2023.

3. Ireland, Cyprus, Malta and Austria are not members of NATO.

4. General Government Fiscal Plan for 2026–2029.

Simulation assumptions: expenditure increase and domestic content of procurement

The calculations in the article make use of the Bank of Finland's Aino model (Kilponen et al., 2016) and the so-called basic model elasticities (BME) for the euro area.[5] The estimated implicit fiscal multipliers in the models will affect the calculation results, as they influence how changes in public revenue and expenditure affect the rest of the economy. For Finland, these multipliers are less than one.[6]

In the simulations, it is assumed, in the case of Finland, that the increase in defence spending towards the 3% level complies with the General Government Fiscal Plan for 2026–2029. Euro area defence spending as a percentage of GDP will be raised in stages by 1 percentage point during the same period (Table 1). With these additions, defence spending as a share of GDP would rise to nearly 3%.

In both simulations, simplifying assumptions are used under which increases in spending in the ministerial sector of the Ministry of Defence are fully allocated to the operational expenses and defence materiel procurement of the Finnish Defence Forces, and under which all the appropriations are used in the year for which they are granted. Half of the additional spending is expected to be allocated to public final consumption expenditure, and half to public investment. It is also assumed that half of the additional spending is to be financed with central government debt, and half through tax increases. The share of the additional spending financed through taxes is further divided equally into direct and indirect taxes, which means that the additional expenditure is financed by e.g. consumption taxes and income taxes. Government bond yields are assumed not to react to the additional expenditure.

In the simulations, assumptions are made about how the additional defence spending would be divided between products made in the euro area and those sourced from other countries. In the first simulation (Simulation 1), the assumption is that all the additional expenditure would be allocated to procurements from Finland and the euro area. This means that all the additional spending would be made and invested in Europe, boosting economic growth. In the second simulation (Simulation 2), the assumption is that half of the additional expenditure would be used for procurements from outside the euro area. This portion of the additional expenditure would not affect GDP, since imports do not add to economic growth in the euro area.

5. For additional information on basic model elasticities (BME) for the euro area, see chapter 3.4, A guide to the Eurosystem/ECB staff macroeconomic projection exercises, ECB, Frankfurt am Main, 7/2016, pp. 26–27. The calculations presented here do not necessarily represent the views of the Eurosystem.
6. The Aino model is a general equilibrium model of Finland's economy that uses the latest available data. It does not incorporate any fiscal multiplier parameters. Instead, the model can be used for assessing what happens to the economy when, for example, public spending is altered, in which case the model will produce an implicit fiscal expenditure multiplier.

Table 1.

Assumptions regarding increase in public demand in Finland and the euro area

Increase in public spending relative to GDP, percentage points					
	2026	2027	2028	2029	Cumulative
Finland	0.0	0.1	0.3	0.4	0.8
Euro area	0.3	0.3	0.3	0.3	1.0

The simulations assume that 50% of the additional expenditure will be financed by indirect and direct taxes in equal proportion. The additional expenditure will be allocated equally between public final consumption expenditure and investment.

Source: calculations by the Bank of Finland.

Simulation 1, in which all the additional expenditure will be allocated to procurements from Finland and the euro area, depicts the upper limit of the impact on GDP. In reality, however, a considerable share of the euro area's current defence procurements are imported from outside the euro area. Nevertheless, although information is available on European defence materiel procurements, the exact percentages can change from year to year, reflecting the timing of large procurements and reporting methods.

There are indications that, since the start of Russia's war in Ukraine in 2022, procurement in Europe has been increasingly directed towards European manufacturers, with their share rising to 52% (International Institute for Strategic Studies, 2024). The Stockholm International Peace Research Institute (Djokic, 2025) estimates that nearly two thirds of European NATO countries' imports in 2020–2024 were from the United States, which is a substantially larger share than in 2015–2019, when it was 52%. On the basis of available data, the assumption of 50% domestic content in Simulation 2 can be deemed realistic, and an even higher rate is possible because the EU is currently actively striving to increase internal procurements in order to strengthen strategic autonomy and the defence industrial base.

Simulation results: increase in defence spending would raise GDP and prices in Finland

Both simulations show output growth and higher prices compared with a situation where defence spending in relation to GDP is no longer increased after 2025. The impacts are significantly larger in Simulation 1 (Table 2).

In Simulation 1 all procurements are made from Finland and the euro area. Finland's GDP will be around 0.7% higher in 2029, due to the substantial increase in demand. Part of the demand growth will be caused by the increase in Finland's public demand, and part by growing demand in the euro area, which will also provide Finland with export opportunities, including opportunities outside the defence industry. The growth in demand will also raise prices, curbing private demand, while tax increases will contribute

to reducing private consumption. This balancing effect must be considered when assessing the overall impact on economic growth. If the euro area's defence industry is unable to meet the rapidly increasing demand quickly enough, there is a risk that the price effects would be larger and the increase in GDP smaller.[7] In such a situation, procurements may also end up being made from outside the euro area.

In Simulation 2, it is assumed that half of the additions to defence spending will be allocated to procurements from outside the euro area, resulting in a zero impact on GDP for that portion. In 2029, GDP will be just 0.3% higher, but on the other hand, the impact on prices will be smaller. This is because import procurements would not raise euro area domestic demand in the same way as purchases made within the euro area, but instead they would increase the total supply in the euro area. Growing imports would also weaken the trade balance, which could lead to an imbalance in the economy.

The calculations indicate the impacts of the different solutions not only on economic growth, but also on inflation and imbalances. On the one hand, imports to Finland from abroad would increase total supply and thus reduce inflation, but on the other hand, the general government debt-to-GDP ratio and the trade deficit would grow.

Table 2.

Results of simulations

GDP Finland, volume and price impact, %

	2026	2027	2028	2029
GDP volume				
Simulation 1	0.0	0.2	0.4	0.7
Simulation 2	0.0	0.1	0.2	0.3
GDP price				
Simulation 1	0.0	0.0	0.2	0.4
Simulation 2	0.0	0.0	0.1	0.3

In Simulation 1, 100% domestic content is assumed, while in Simulation 2 the assumption is 50%. In Simulation 2, it is assumed that 50% of the procurements are imported from outside the euro area, with no impact on growth. In both simulations, 50% of the additional defence expenditure is assumed to be financed through tax increases.

Source: calculations by the Bank of Finland.

7. Antonova et al. (2025) show that, in the short term, the multiplier can fall significantly below 1, because allocating resources to military production is costly. These costs will depend on the initial circumstances, such as the structure of the industry and the frictions involved in reallocating capital.

How would an increase in defence spending affect public finances?

In the calculations presented, Finland's defence spending as a percentage of GDP is expected to rise towards 3% in accordance with the General Government Fiscal Plan for 2026–2029 and the simplifying assumptions described above. This will cause Finland's general government deficit-to-GDP ratio to grow by 0.2 percentage points in 2028 and by 0.4 percentage points in 2029 compared with the baseline (Table 3). The estimated impacts on the public finances are static, which means the transformed economic landscape in the simulations will not affect public revenues or public expenditure via economic activity or prices.

The calculations show an increase in general government debt, but the impact on the debt ratio depends on the simulation in question. In Simulation 1, a stronger impact on nominal GDP will reduce the general government debt as a percentage of GDP. In Simulation 2, the impact will be similar in nature but noticeably weaker, and the debt ratio will remain largely unchanged.

Table 3.

Change in general government net lending and debt ratios relative to the baseline

	2026	2027	2028	2029
Change in net lending in relation to GDP, percentage points				
Simulation 1	0.0	-0.1	-0.2	-0.4
Simulation 2	0.0	-0.1	-0.2	-0.4
Change in debt in relation to GDP, percentage points				
Simulation 1	0.0	-0.1	-0.3	-0.3
Simulation 2	0.0	0.0	0.0	0.1

In Simulation 1, 100% domestic content is assumed, while in Simulation 2 the assumption is 50%.

In Simulation 2, it is assumed that 50% of the procurements are imported from outside the euro area. In both simulations, 50% of the additional defence expenditure is assumed to be financed through tax increases.

Source: calculations by the Bank of Finland.

If defence spending were kept at this new, higher level, or if it were to be further increased after 2029, the accumulation of further public debt would mean that a sustainable source of finance would need to be found for this spending by cutting other public expenditure or through permanent tax increases. Otherwise, the rising debt ratio would accelerate again after 2029, when the contribution of GDP growth would no longer

compensate for the impact of a higher deficit on the debt ratio. As with the tax increases in 2027–2029 included in the simulations, new fiscal adjustments would probably have a negative impact on economic growth. On the other hand, the simulations indicate that financing higher defence spending at least partially through tax revenue curbs growth in indebtedness.

The European Commission (2025) has recently estimated the effects of higher defence spending on the EU economy. The assumptions made in the Commission's calculations differ somewhat from those in this article. The Commission's calculations assume that defence spending will grow by 1.5% of GDP by 2028. The additional spending will initially be fully debt-financed, but after 2028 the augmented defence spending would be increasingly financed through taxes. The Commission assesses that the increase in defence spending will raise real GDP by 0.3%–0.6% by 2028, depending on the domestic content of the defence procurements, which is qualitatively in line with the results presented here. However, in the Commission's calculations the public debt ratio of EU member states would still grow by a further 2 percentage points (i.e. more than in this article's calculations), due to debt financing and higher spending.

EU allowing divergence from common debt rules to boost defence capabilities

The European Commission has proposed that it be possible to activate a national escape clause under the EU fiscal rules for the purpose of boosting defence spending. By the end of April, 16 EU Member States (including Finland) had applied for this clause to be triggered. This would allow extra defence expenditure of up to 1.5% of GDP (compared with defence spending in 2021), and this spending would be excluded from the monitoring of compliance with the fiscal rules, provided that debt sustainability is secured. The escape clause would be valid during 2025–2028. In March 2025, the Commission assessed that the additional flexibility would allow Member States to increase their defence spending by as much as EUR 650 billion over four years. In addition, a Regulation for a EUR 150 billion Security Action for Europe (SAFE) instrument is in preparation, through which EU countries would be able to borrow money for common defence procurement.

In Finland, the escape clause activation would come at a favourable time, because the expenditure on the fighter aircraft procurement covers the years 2022–2030. In 2025–2028, around EUR 1.5 billion annually will be spent on payments for the fighter jets, which corresponds to slightly over 0.5% of GDP. Defence spending has also been pushed up by other measures to strengthen national defence and by procurements to replace material support given to Ukraine. So far, payments for the fighter aircraft procurement have increased the government borrowing requirement, but have not increased the deficit (as defined in the National Accounts). When the aircraft deliveries begin, the costs will be recorded as public investment, and thus also as defence spending under the COFOG classification, which will be examined when assessing compliance with the escape clause.

Once the escape clause expires, countries must be able to finance their higher defence spending through tax revenues or by reducing other expenditure, and not through borrowing. It is important to prepare for this situation while the escape clause is still in force.

Calculations provide an indication of the impacts

The change in the global security environment requires a strengthening of defence capabilities in Europe, and many European countries have announced increases in defence spending.

Higher defence spending will have significant economic implications that should be assessed in advance. Although different calculations provide valuable information, they are indicative only and are, of course, subject to uncertainty. The results presented could

be affected by, for example, the general government budgetary position and general government debt level. Government debt is already high and this could reduce the growth impacts. The impacts on economic growth would be smaller if government bond yields were to react to higher indebtedness, and if monetary policy intervention were also required. Fiscal multipliers, or the degree to which changes in public spending or taxation affect economic growth, are subject to uncertainty, and this will be affected by many factors, such as cyclical conditions and the prevailing monetary policy stance. The extent to which the higher defence spending is allocated to final consumption or investment can also have an impact. It is important to note that the assumptions and multipliers used in economic modelling are based on historical data and models that may no longer be valid in the future, due to changing circumstances.[8]

According to the literature, the fiscal multipliers related to military expenditure are positive, meaning that the economy will expand as military spending increases. On the other hand, estimates of the scale of the impact vary (Ilzetzki, 2025). The impact on economic activity estimated in this article is within the range reported in the literature.

The degree of openness of an economy also affects the fiscal multipliers. In open economies, part of the effect leaks abroad through imports, which reduces the multiplier. This aspect, in particular, is emphasised here, as the article highlights the importance of the country of origin of defence procurements and the potential impact of this on Finland's economy. An increase in defence spending would boost GDP and raise prices compared with a situation in which defence spending would no longer be increased after 2025. The impacts are significantly greater in the simulation in which all the procurement is from the euro area. Different weightings and assumptions regarding the transmission channels, amounts and allocation of defence spending would produce slightly varying results.

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8. This article does not recount the fiscal multipliers presented in the literature, but readers who would like to know more can consult publications such as Ramey (2016), Corbo et al. (2015), Ramey (2011), Farhi and Werning (2016), and Ilzetzki (2025).

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Tags

euro area, defence spending, NATO (North Atlantic Treaty Organization), GDP, simulations, Finland