



**The economics
of defence: How
defence investment
can drive UK
industry and
economic growth**

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Foreword



Rupert Pearce
UK National
Armaments Director

In early March, the UK Ministry of Defence (MOD) announced a new contract with a family-run Midlands business. They have been casting, welding and forging metal since 1910, and will now produce chains and anchors for Royal Navy warships for many years to come.

In one fell swoop, this contract invests in a local business and their regional supply chain, supports UK skills and employment, and delivers a high-quality product that makes our ships safer.

The first duty of the MOD is to protect the UK and its people, and to stand with our allies in NATO and around the world. But we should not see the power of Defence to be an engine for growth as something separate from that. In fact, a robust, thriving economy, built on sovereign capabilities, is crucial to our nation's resilience and security.

UK defence spending is increasing at a dramatic rate and, as this excellent paper makes clear, that creates enormous investment potential. Correctly channelled towards domestic industries, this has the potential to boost productivity, innovation and supply chain resilience, driving long-term growth across all regions of the UK and benefiting the wider economy.

The authors are correct to diagnose that unlocking these significant economic gains requires policy makers, delivery agents, industry, academia and investors to work together in new ways that reflect the urgency of the times we live in.

The MOD is undertaking dramatic reforms to its structures and procurement processes that aim to address long-standing acquisition and investment challenges, and create more opportunities for companies, organisations and investment funds to work with us, not just for us.

As National Armaments Director, I am backing UK industry all the way and committing every person in the MOD's new National Armaments Director Group to pursue effective partnerships across our growing Defence sector.

We have a chance now to mature the UK's defence industrial enterprise through investment and engagement with companies of all sizes and backgrounds. This demands genuine collaboration, and a shared sense of our national purpose, as well as our economic and defence priorities.

By working in unison, we can support prototype innovation, manufacturing capabilities, and greater growth through dual-use and export opportunities. And we can ensure our defence ecosystem is able to step up to wartime pace and resilience when required, becoming an essential component of the UK's ability to deter and respond to any threat.

Background: the rising importance of defence

In the post-pandemic era, severe economic and geostrategic volatility has buffeted the global economy and challenged long-held certainties around national security and resilience. Western Europe has been particularly impacted, with supply chain disruptions, global conflicts and now tariffs exposing weaknesses in regulatory, industrial and energy policy.

Global security has deteriorated, with the 2022 Russian invasion of Ukraine signalling the end of the post-Cold War peace dividend and highlighting the growing risks of 'hot conflicts'. At the same time, the US government has put pressure on European states to shoulder a greater share of their defence spending, to reduce reliance on the US.

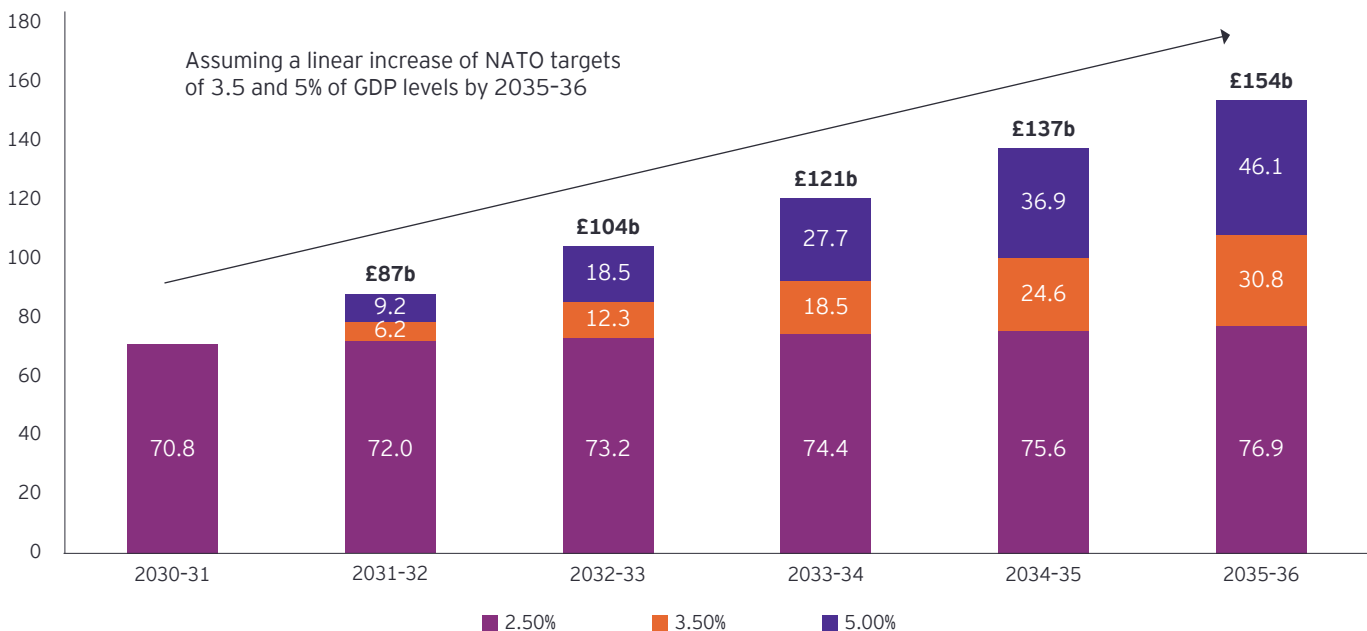
Consequently, European NATO members, many of whom did not meet the previous 2% GDP target until recently (or still do not),¹ have committed to accelerating defence spending over the next decade. At the Hague Summit in June 2025, all NATO members agreed to a target of at least 5% of GDP annually by 2035.² Within this, at least 3.5% of GDP must be allocated to core defence spending, with an additional 1.5% in investments to improve resilience in critical infrastructure and strengthen the defence industrial base.

The UK planned for higher defence investment, even before the new NATO targets

In 2023-24, the UK spent £54bn on defence, enough to meet the 2% target. In its March 2025 Spring Statement, the Labour government subsequently pledged a short-term rise from 2.3% to 2.5%, funded via cuts in foreign aid. The June Spending Review then allocated additional funding in line with the higher 2.5% target.³ As a result, defence spending is expected to grow by an average of just under 4% in real terms over the next four years, reaching £70bn by 2030. According to the Office for Budget Responsibility (OBR), diverting funds from foreign aid to defence should increase real GDP by up to 0.06% in the near term.⁴

Further, in line with other NATO members, the UK has now committed to raise spending to 3.5%-5.0% of GDP by 2035.⁵ Interestingly, between 2014 and 2025, the UK experienced the lowest defence expenditure growth of any NATO country, causing it to descend the ranks of contributions as a proportion of GDP. Ramping up to these new targets, therefore, calls for a steep rise in defence funding – beyond the levels currently provisioned. EY estimates (based on OBR forecasts and projections of GDP) suggest that meeting the 3.5% goal would require an additional annual £31bn of real-term spending by 2035; while meeting the 5% target would require a further £77bn – compared with maintaining the 2.5% ambition.

Estimated impact on defence expenditure of a 3.5% and 5% NATO target | £bn annual real-terms spend



Calculations done using the OBR March 2025 GDP forecast up to 2029-30 and then EY projection from 2030-31.

Source: OBR, EY calculations.

Fiscal limitations could hinder funding

The UK's ambitious spending plans must overcome the harsh realities of a weak economy and low productivity, which rule out substantial borrowing increases. The delayed publication of the Defence Investment Plan (amid reports that the Ministry of Defence faces a multibillion-pound funding 'black hole') might also indicate that higher expenditure will first have to balance existing overspends.

Even more reason to use defence spending as an economic policy lever, investing in UK industrial capability and, in turn, growing the economy. This means maximising the amount of military material designed, built, operated and serviced in the UK, while maintaining quality, to ensure our service men and women have the best fighting capability.

Increased defence spending could permanently raise UK GDP by £30bn a year

EY modelling suggests that the proposed defence spending increase could have long-term economic benefits, permanently pushing up growth and productivity – over and above any short-term boost to demand from additional spending. By 2045, UK GDP could be up to 0.8% per annum larger – roughly £30bn per annum in real, additional economic output.

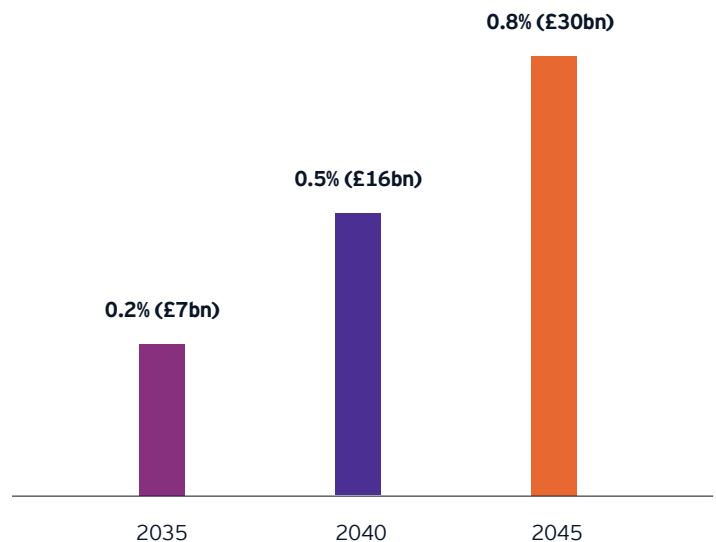
Prioritising UK design and manufacture should also bring other advantages, including the creation, maintenance and retention of skilled employment – often in non-traditional industrial heartlands, in line with the government's stated intent to support regional growth.

It is also entirely consistent with the government's Modern Industrial Strategy⁶ – where the defence industry is identified as one of eight priority sectors (i.e., one of the IS-8)

Additionally, investing in British design and manufacturing (particularly amongst small and medium-sized enterprises (SMEs)) encourages competition and retains intellectual property (IP) – and thus the value of the investment. A robust domestic defence industry helps build national self-sufficiency and enables exports at a time when world demand is likely to grow.

With national security and readiness becoming a major priority, a strong domestic defence industry maintains sovereignty and assures access to critical supplies when needed.

Modelled Impact on GDP level increasing defence spending to 5% | % and £bn, real-terms



Source: EY calculations using the NiGEM model.

Maximising value

The scale of the economic impact will depend on four factors:

What
the money
is spent on

Who
the money is
spent with

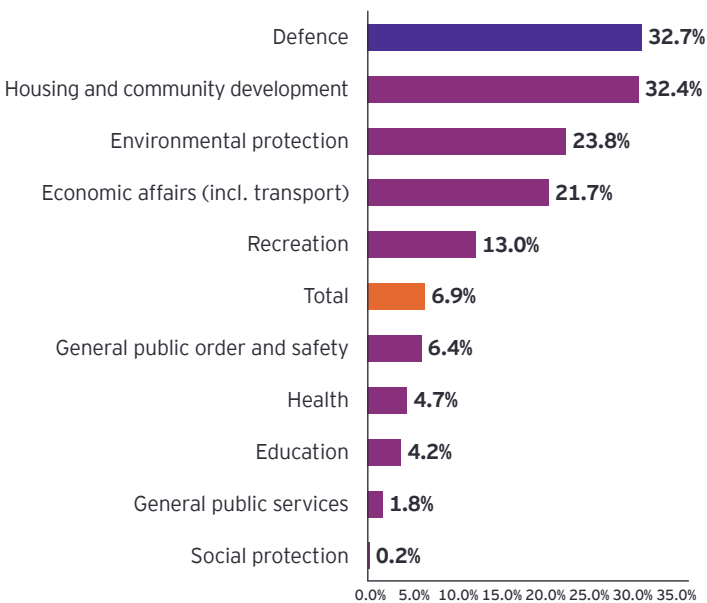
Where
the money
is spent

When
the money
is spent

What the money is spent on

UK government defence expenditure is, along with housing and community development, the most capital-intensive of any area of government spending. Almost one-third of the budget (c.£20bn) is classified as capital departmental expenditure limit (CDEL, e.g., infrastructure, equipment and technology), rather than resource departmental expenditure limit (RDEL, e.g., day-to-day spending on salaries, consumables and accommodation).

Capital investment share of total expenditure, % 2023



Source: ONS, general government expenditure.

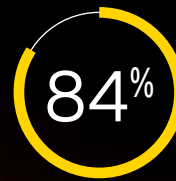
If this capital intensity persists, defence spending increases are likely to disproportionately enhance long-run growth and productivity. This is because they would raise the UK's capital stock (i.e., value of the UK's productive assets), which provides a strong foundation for jobs and innovation. Less capital-intensive forms of government expenditure, by contrast, tend to produce higher wages but fail to raise longer-term productivity.

Maintaining or increasing spend in equipment, munitions and technology (supported by a domestic industrial base) won't just expand the UK defence sector's capability and capacity. Defence-driven innovation can also help the wider economy, where advances in aviation, cybersecurity, artificial intelligence (AI), quantum computing, energy efficiency and biotechnology can all be applied to domestic commercial markets in the form of 'dual-use' technologies.

Who the money is spent with

The UK has a successful indigenous defence industry, including several world-leading listed 'primes', each supported by extensive supply chains of specialised smaller organisations. The industry is also relatively self-sufficient: 84% of its sourcing comes from UK-based suppliers, compared with an average of 60% for the wider manufacturing sector.

When UK suppliers' own foreign supply chains are factored in, almost 70% of the UK defence budget is spent within the domestic economy. Maintaining a high proportion of defence spending within the UK – or even increasing it – would boost the domestic defence industry and its supply chain, enabling UK businesses to scale up and attract both domestic and international investment. Larger defence manufacturers tend to be international, with a degree of skills, IP and manufacturing developed overseas – effectively 'leaking' value outside the UK. In its procurement, the MOD could, where practical, look to support suppliers that seek to maximise the value of their domestic supply chain. The government's Defence Industrial Strategy pledges that investments in overseas suppliers will bring new jobs and technologies to the UK.⁷



Currently, the MOD spends **84%** of its global spend with industry in the UK.¹



Around **18%** of the inputs used by the UK defence manufacturing sectors² are imported.³



This means an estimated **69%** of the MOD spending with industry goes to UK suppliers, with 31% going abroad either directly or through UK firm's supply chains.

1. "MOD regional expenditure with industry 2024/25," gov.uk website, <https://www.gov.uk/government/statistics/mod-regional-expenditure-statistics-with-industry-202425/mod-regional-expenditure-with-industry-202425>, accessed October 2025.

2. Manufacturing subsectors: weapons and ammunition, ships and boats, aircraft and spacecraft, and other transport equipment.

3. Calculation done using ONS UK input-output analytical tables: 2022.

A thriving domestic defence sector is dependent upon a pipeline of smaller, entrepreneurial companies that can grow into future stars. However, only 4% of MOD expenditure is with SMEs,⁸ with the majority of procurements dominated by a few large suppliers. If the UK is to build up its defence force at pace, it needs to invest in the capability and capacity of domestic companies of all sizes across the supply chain, and consider how it engages with and contracts SMEs. The scale and speed of growth also call for private capital, and the MOD should reach out to investors to highlight the opportunity.

Where the money is spent

Defence is an important part of the UK's regional growth strategy, to rebalance the economy and address geographical disparities. This calls for conscious decision-making on where to set up businesses and clusters, while considering regional economic impacts and national security needs. The government recently announced a new team dedicated to supporting small British businesses to win more defence contracts. Thirty 'pathfinder' SMEs have initially been selected as part of a drive to spend £2.5bn more with this critical sector,⁹ in a bid to generate future stars. In another initiative, £250mn in funding has been earmarked for Defence Growth Deals in a range of areas around the UK.¹⁰ Creating stronger manufacturing and supply chains within the UK also reinforces national security by reducing reliance on other nations.

When the money is spent

While due diligence is paramount, lengthy procurement processes can deter potential bidders – especially SMEs with smaller cash buffers. Sourcing decisions should balance equipment specification, value for money, speed of supply and diversity of the supplier base. The speed of technological change also demands fast procurement, to ensure readiness and help develop 'the defence industry we don't realise we need', to remain on the cutting edge of new weaponry and systems. Government could, therefore, streamline procurement processes and accelerate decision-making where possible, albeit balanced with the need to maintain transparency and value for money.

Key actions for government, defence industry and investors

In strengthening its defence capability, the UK is attempting to increase national security through a robust domestic defence industry capable of meeting future demands and resilient to continuing geopolitical shocks. In doing so, it also has an opportunity to boost GDP and growth:

Policy actions:

1. Consider the wider economic benefits of increased defence spending in the budgeting process.
2. Ensure alignment between the MOD, the Department for Business and Trade (DBT) and other relevant departments on the role of defence in the Modern Industrial Strategy.
3. Clarify the regulatory position of the defence sector regarding environmental, social and governance (ESG) obligations.
4. Define procurement needs and priorities to give the industry confidence to invest to scale up capacity and capability.

Delivery actions:

1. Determine current and future needs, to confidently engage with alternative sources of capital to develop an evolved defence industry.
2. Balance off-the-shelf equipment purchases (to meet immediate needs) vs. longer-term investments in UK manufacturing capability that build resilience.
3. Reform procurement processes to shift from low-volume, high-cost, long-life platforms to higher-volume, low-cost, expendable consumables.
4. Engage with and commit to SMEs early in the procurement process, enabling them to access capital to upscale.
5. Encourage and increase dual-use technology development amongst primes and their suppliers to de-risk operations and attract additional funding.
6. Gain governmental support to grow export opportunities to support greater scale.

Conclusions

As the post-Cold War peace dividend recedes, governments across the world, and particularly in Western Europe, are rapidly re-investing in security and defence. By harnessing defence as a tool of industrial strategy, they can overcome fiscal constraints, using increased defence spending as a lever for accelerated economic growth, alongside increased employment and a wider skills base. Governments, the defence industry and investors will need to work closely together to deliver both security and economic priorities.

Technical appendix

To estimate the potential long-term economic benefits from higher defence spending, the EY team undertook modelling using the National Institute of Economic and Social Research's Global Economic Model (NiGEM). NiGEM is a structural, macroeconomic model with full coverage of the UK economy (consisting of over 300 individual macroeconomic variables) and over 60 other countries and regions.

NiGEM can therefore be used to conduct scenario modelling to estimate the long-term, steady-state impact of changes to UK government policy, compared with a baseline forecast.

The analysis presented in this article modelled the impact of two scenarios:

1 Defence spending permanently increased to 3.5% of GDP by 2035

2 Defence spending permanently increased to 5.0% of GDP by 2035

The modelling was conditioned on several assumptions:

- The share of capital investment within total defence spending is permanently maintained at its current level (one-third of total spending).
- The increase in defence spending is funded by offsetting reductions in current (i.e., non-capital) expenditure in other areas.
- The additional investment is allocated towards the UK economy in at least the same proportion as previously (i.e., the additional spend is not predominantly directed towards foreign suppliers).

These assumptions were applied to model an estimate of a more 'maximalist' beneficial impact from an increase in defence spending. This informed an analysis of the potential benefits of using defence spending as a tool to drive economic growth.

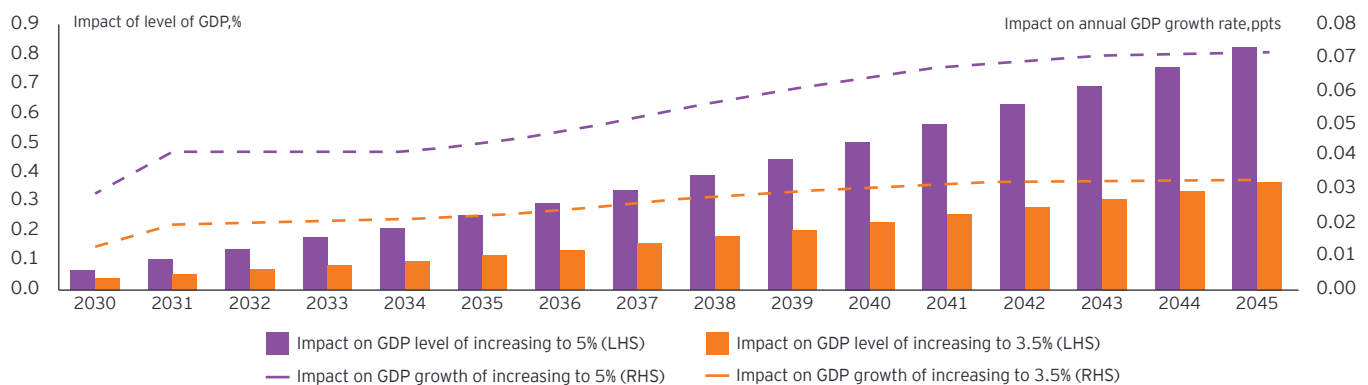
The key limitations of the modelled results are therefore largely regarding the extent to which these assumptions are not met. If the additional spending is primarily directed towards current expenditure (such as staff costs), or is met by increased imports, or is funded via tax rises or cuts to non-resource expenditure, then any economic impacts would likely be smaller than those presented in this article.

The mechanism by which increased defence spending boosts growth in the modelled scenarios is as follows:

- The increase in defence spending, funded by offsetting cuts to other resource spending, is modelled as an increase to government investment fully offset by a net reduction in government consumption, with no overall change to total government expenditure or taxation.
- To illustrate this, in 2035, the £77bn of increased defence spending under the 5.0% of GDP scenario is modelled as an annual increase in government investment of just over £25bn, with an offsetting reduction in government consumption of £25bn, meaning there is no change in headline government spending.
- The remaining two-thirds of non-capital defence expenditure is treated as government consumption and is assumed to be funded by re-allocation of existing spend, so has no impact on overall headline government consumption.
- The increase to government investment leads to a higher overall capital stock.
- The capital stock is an input into production, so a larger capital stock increases overall productivity.
- Higher productivity growth permanently increases the overall productive capacity of the economy and lifts the trend rate of growth, delivering a permanent increase to the growth rate of GDP.

The chart below shows the modelled impact on GDP growth and levels (compared with the baseline forecast) up to 2045 in both the 2.5% and 5.0% scenarios.

Modelled GDP impact of increased defence spending | Increase over base forecast (%level/ppt annual growth rate)



Source: EY calculations using the NiGEM Model.

Endnotes

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