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The Fiscal Implications of Meeting the NATO Military Spending Target

OFFICE OF THE PARLIAMENTARY BUDGET OFFICER
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The Parliamentary Budget Officer (PBO) supports Parliament by providing economic and financial analysis for the purposes of raising the quality of parliamentary debate and promoting greater budget transparency and accountability.

This report examines the fiscal implications of Canada's recent commitment to meet NATO's military spending target of 2% of GDP by 2032.

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Highlights

Canada has recently committed to meeting NATO's 2% of GDP military spending target by 2032-33. According to a PBO hypothetical scenario where this target is met, defence spending would have to nearly double as compared to projections of spending for the current fiscal year (2024-25).

DND figures released along with its new defence policy, Our North Strong and Free: A Renewed Vision for Canada's Defence, project military spending to reach 1.76% of GDP by 2029-30, but these figures are based on an erroneous GDP forecast. Adjusting for the correct GDP growth rates, military spending only reaches 1.58% of GDP by 2029-30, leaving a 0.42 percentage point gap to meet the 2% target by 2032-33.

In the hypothetical scenario, the debt-to-GDP ratio initially remains stable before beginning a gradual decline, reaching 38.2% by 2032-33, suggesting that the government can still achieve its goal of a declining debt-to-GDP ratio despite increased military expenditures.

The deficit-to-GDP ratio would be impacted more substantially over the medium term by the increased military spending, failing to reach the stated goal of 1% of GDP by 2026-27, and may exceed guidelines in the latter years of the forecast.

Summary

On July 11th, 2024, the Government of Canada announced its commitment to meet NATO's military spending target of 2% of GDP by 2032. This announcement followed the release of the defence policy Our North Strong and Free: A Renewed Vision for Canada's Defence (ONSAF) in April 2024, which projected military spending to reach 1.76% of GDP by 2029-30. The government has yet to release figures detailing how it will further increase spending to achieve the 2% target.

However, the nominal GDP growth rates applied in the ONSAF forecast for fiscal years 2025-26 through 2029-30 average around 1.7%, a rate that fails to outpace inflation and therefore implies a four-year economic recession. Using PBO GDP figures, which are broadly in line with the Department of Finance and other independent sources, the recalculated forecast places defence spending at just 1.58% of GDP by 2029-30, revealing a gap of 0.42 percentage points to be filled by the 2032-33 target year.

This report evaluates the fiscal implications of a hypothetical scenario that bridges the remaining gap left by the military spending projection in ONSAF to reach 2% of GDP by 2032-33. This scenario assumes that the ONSAF expenditure levels are fully realized through 2029-30, after which additional increments are implemented to raise military spending to 2% of GDP by the 2032-33 fiscal year. According to this projection, defence expenditures would need to reach $81.9 billion by 2032-33, almost double the projected amount for 2024-25 ($41 billion). This increase requires a rapid escalation in expenditures following the conclusion of ONSAF in 2029-30, when spending levels are forecasted to reach only $57.8 billion.

Regarding the debt-to-GDP ratio, the analysis shows that, despite the sharp rise in military expenditure, it is feasible to maintain the government's objective of a declining ratio over the medium term. While the baseline scenario, aligned with the PBO's October 2024 Economic and Fiscal Outlook, projects a steady decline starting from 2024-25, the hypothetical scenario maintains a similar downward trend, with the debt-to-GDP ratio reaching 38.2% by 2032-33, slightly above the baseline forecast of 36.6%.

Conversely, the hypothetical scenario poses challenges to achieving the government's deficit-to-GDP fiscal objective. The baseline forecast anticipates the deficit-to-GDP ratio will fall below 1% in 2026-27 and continue to decline in the subsequent years. In contrast, the hypothetical scenario shows a deficit-to-GDP ratio that only decreases to 1.08% in 2026-27, failing to meet the target. While the ratio eventually drops below 1%

two years later, it begins rising in the final years of the projection, again exceeding 1% in 2032-33 due to the intensified spending required to bridge the 0.42 percentage point gap in military spending-to-GDP left after ONSAF's conclusion.

Introduction

In 2006, NATO member nations set a policy goal to allocate at least 2% of their GDP to annual defence spending. While some countries, most notably the United States, exceeded this target, the majority fell short. After eight years of limited progress, NATO members reaffirmed their commitment to this goal in 2014. Since this time, Canada has consistently remained below the 2% threshold, and as of 2024, it is one of only eight member nations still failing to meet the target, with projected defence expenditures totaling only 1.37% of GDP.[1]

On July 11th, 2024, the Government of Canada announced its commitment to meet NATO's military spending target of 2% of GDP by 2032.[2] According to the government's new defence policy, Our North Strong and Free: A Renewed Vision for Canada's Defence (ONSAF), released in April 2024, total military expenditure is forecasted to rise from its projected level of $41.0 billion in the 2024-25 fiscal year to a total of $57.8 billion by 2029-30, which the Department of National Defence (DND) projects would represent 1.76% of GDP in that fiscal year.[3,4]

Despite this announcement, the government has yet to release figures detailing how it will further increase defence spending to reach the 2% target by 2032. New investment initiatives that were not included in the initial funding projection for ONSAF, such as the Canadian Patrol Submarine Project, are expected to contribute to increased spending after 2029-30.

Recent PBO analysis on the topic of military spending and the NATO 2% target, released in July of this year, produced an independent forecast of Canada's military expenditures under the NATO definition. This work predated the government's commitment to meet the 2% target by 2032.

This report complements the July 2024 analysis by providing an alternate forecast that assumes the government will fulfill its commitments outlined in ONSAF and reach the 2% spending target by the 2032-33 fiscal year. The objective of this report is to evaluate whether these projections align with the Government of Canada's fiscal objectives: reducing the debt-to-GDP ratio from 2024-25 onwards and maintaining a declining deficit-to-GDP ratio below 1% by 2026-27 and beyond. This analysis therefore assesses the feasibility of meeting the NATO defence spending target while respecting the government's stated fiscal sustainability guidelines.

The ONSAF forecast of military spending and GDP

Table 1 presents Canada's forecasted military expenditures, nominal GDP, economic growth rates, and defence spending as a percentage of GDP under the ONSAF policy for the period 2024-25 to 2029-30.[5] The table also includes the PBO's independent forecast of nominal GDP and economic growth rates, along with the recalculated defence spending-to-GDP ratio based on the PBO's GDP figures.

According to the ONSAF forecast, defence spending-to-GDP reaches 1.76% in 2029-30, suggesting that the 2% target is just under a quarter of a percentage point away from being met. However, the 1.76% figure is based on an erroneous GDP forecast: the nominal GDP growth rates applied in this forecast for fiscal years 2025-26 through 2029-30 average around 1.7%. Such low growth rates are unlikely to outpace inflation and imply a four-year economic recession, almost twice the length of the country's longest recession in the last 40 years.[6]

Substituting the erroneous GDP forecast with the PBO's figures, which are comparable to those from the Department of Finance and other independent sources, projected defence spending reaches only 1.58% of GDP by 2029-30. To meet the target by 2032-33, defence expenditures would need to increase by an additional 0.42 percentage points of GDP over the intervening years while keeping pace with the expected growth rate of nominal GDP. The rate of increase in military spending needed to reach the 2% threshold by 2032-33 is therefore significantly higher than in the case where the ONSAF figure of 1.76% is reached by 2029-30.

Table 1

ONSAF Military Spending and GDP Projections compared to PBO Forecast

Fiscal year	2024–25	2025–26	2026-27	2027-28	2028-29	2029-30
Canadian Defence - Projected Spend ($ billions)	41.0	52.3	53.2	53.5	54.9	57.8
ONSAF Forecast Canadian GDP ($ billions)	2,958.0	3,071.6	3,124.6	3,176.9	3,231.1	3,285.6
ONSAF nominal GDP growth rate	-	3.8%	1.7%	1.7%	1.7%	1.7%
Defence Spending to GDP (ONSAF GDP)	1.39%	1.70%	1.70%	1.68%	1.70%	1.76%
PBO Forecast of Canadian GDP ($ billions)	3,034.0	3,139.5	3,253.8	3,382.2	3,514.7	3,656.5
PBO nominal GDP growth rate	-	3.5%	3.6%	3.9%	3.9%	4.0%
Defence Spending to GDP (PBO GDP)	1.35%	1.67%	1.63%	1.58%	1.56%	1.58%

Source:

Department of National Defence, Office of the Parliamentary Budget Officer.

Note:

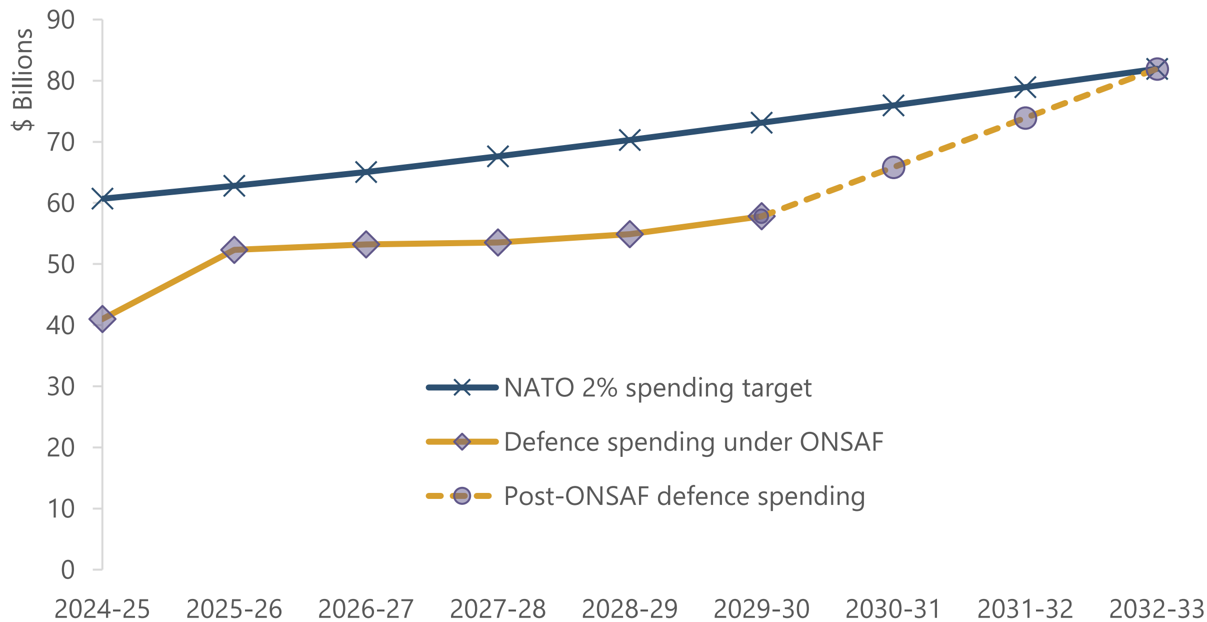
ONSAF GDP figures sourced from Our North Strong and Free: A Renewed Vision for Canada's Defence, Addendum: National Defence Funding and Projected Canadian Defence Spending to GDP.[7]

Reaching the 2% of GDP defence spending target: a hypothetical scenario

To evaluate the fiscal implications of Canada reaching the 2% target by the 2032-33 fiscal year,[8] a hypothetical expenditure forecast aligned with this goal is necessary. PBO develops this forecast (Figure 1) by assuming that the total defence spending projected under ONSAF is fully realized through 2029-30. The shortfall between the defence expenditure in 2029-30 (1.58% of GDP) and the 2% target is then addressed over the following three years, with spending adjusted incrementally to ensure that military expenditure reaches exactly 2% of GDP by the 2032-33 fiscal year.

According to this forecast, military spending would need to reach $81.9 billion by the 2032-33 fiscal year, nearly double the projected $41 billion expenditure for 2024-25. This increase requires a rapid escalation in expenditures following the conclusion of ONSAF in 2029-30, when spending levels are forecasted to reach only $57.8 billion.

Figure 1
Hypothetical forecast of military spending meeting the NATO 2% commitment by 2032-33



Fiscal Year	Hypothetical forecast ($ billions)	Defence spending to GDP	NATO 2% target spending ($ billions)
2024-25	41.0	1.35%	60.7
2025-26	52.3	1.67%	62.8
2026-27	53.2	1.63%	65.1
2027-28	53.5	1.58%	67.6
2028-29	54.9	1.56%	70.3
2029-30	57.8	1.58%	73.1
2030-31	65.8	1.73%	76.0
2031-32	73.9	1.87%	78.9
2032-33	81.9	2.00%	81.9

Source:

Department of National Defence, Office of the Parliamentary Budget Officer.

Note:

Defence Spending under ONSAF sourced from Addendum to ONSAF. Defence Spending figures after 2029-30 are based on PBO calculations.

The impact of increased military spending on Canada's fiscal objectives

To evaluate the potential impact of the increased military spending needed to meet NATO's 2% target by the 2032-33 fiscal year on Canada's fiscal objectives, it is first important to distinguish between cash and accrual accounting and understand their implications for such an analysis.

NATO's military expenditure target is fundamentally based on cash accounting, where it considers actual military expenditures in a given year. Conversely, Canada's fiscal objectives are assessed using an accrual-based approach. While there is minimal discrepancy between these accounting methods for operational expenditures, the treatment of capital expenditures diverges significantly - an important consideration given that Canada's spending on major equipment is projected to eventually exceed 30% of total military spending on an ongoing basis.

In an accrual-based system, capital assets, particularly in the defence sector, are amortized over their useful life, while in a cash-based approach, expenditures are recorded upfront as assets are purchased and deployed. Consequently, it is possible to increase capital spending quickly on a cash basis, which may facilitate meeting the 2% target in the medium term. However, under an accrual approach, much of this expenditure would only be reflected gradually as the assets come into service, which may limit the impact on the government's stated fiscal objectives.

Hypothetical versus baseline approach

The PBO's October 2024 Economic and Fiscal Outlook serves as the baseline upon which the hypothetical spending scenario is compared. In constructing the hypothetical scenario in accrual terms, capital expenditures attributed to defence are deducted from the baseline and replaced with the new, higher series reflecting the accrual accounting assessment of the capital spending (major equipment spending) needed to meet the 2% expenditure target by 2032-33. Similarly, the operating costs from the hypothetical scenario replace the corresponding baseline costs.

The government of Canada’s fiscal objectives

As outlined in the 2023 Fall Economic Statement and Budget 2024, the government’s key fiscal objectives include keeping the 2023-24 deficit at or below $40.1 billion, reducing the debt-to-GDP ratio from 2024-25 onwards, and maintaining a declining deficit-to-GDP ratio below 1% by 2026-27 and beyond. The latter two fiscal objectives are relevant to the current analysis as the hypothetical military spending profile raises spending above the fiscal baseline for each fiscal year from 2024-25 to 2032-33.

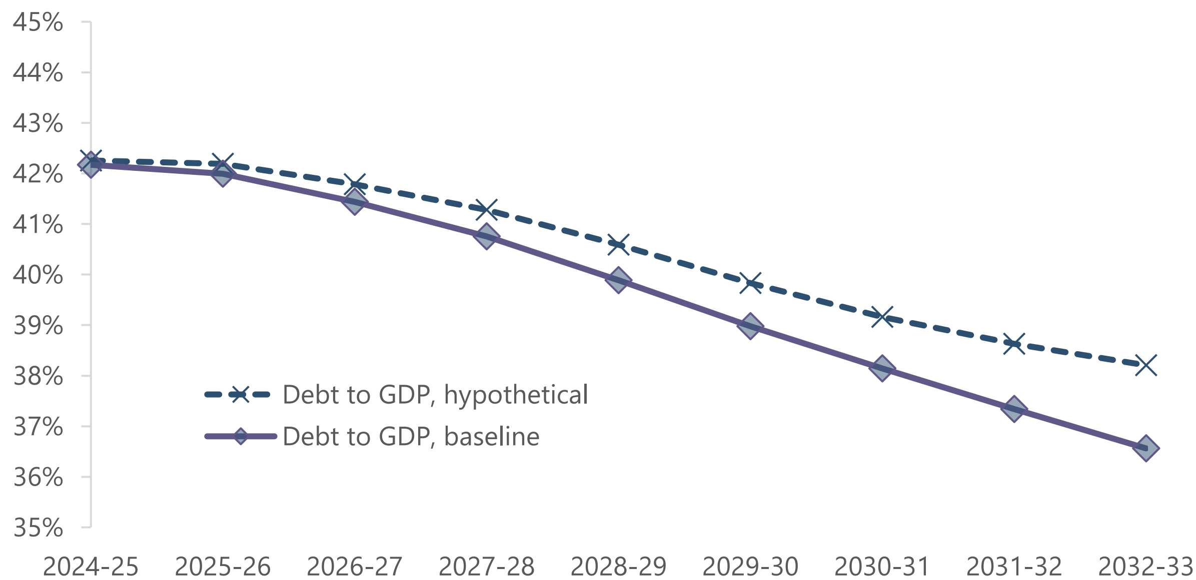
Impact on debt-to-GDP ratio

Figure 2 illustrates the comparison between the hypothetical scenario and the baseline. The analysis demonstrates that it is feasible to achieve the fiscal objective of maintaining a declining debt-to-GDP ratio over the medium term while increasing defence spending to the extent necessary to reach 2% of GDP by 2032-33.

In the baseline scenario, consistent with the PBO’s October 2024 Economic and Fiscal Outlook, the federal debt-to-GDP ratio is projected to remain stable over the next few fiscal years, at around 42%, before beginning a downward trend in the medium term.

In the hypothetical scenario, the additional military expenditures under ONSAF and beyond maintain a declining debt-to-GDP ratio, though it remains consistently higher than in the baseline. By the latter years of the ONSAF defence policy and the period leading up to the 2032-33 target year, the ratio declines to 38.2%, somewhat higher than the level of 36.6% in the baseline scenario.

Figure 2
Hypothetical forecast of debt-to-GDP ratio versus baseline



Fiscal Year	Hypothetical	Baseline
2024-25	42.3%	42.2%
2025-26	42.2%	42.0%
2026-27	41.8%	41.4%
2027-28	41.3%	40.8%
2028-29	40.6%	39.9%
2029-30	39.8%	39.0%
2030-31	39.2%	38.1%
2031-32	38.6%	37.3%
2032-33	38.2%	36.6%

Source:
Office of the Parliamentary Budget Officer.

Note:
PBO calculations based on inputs from National Defence and other PBO works.

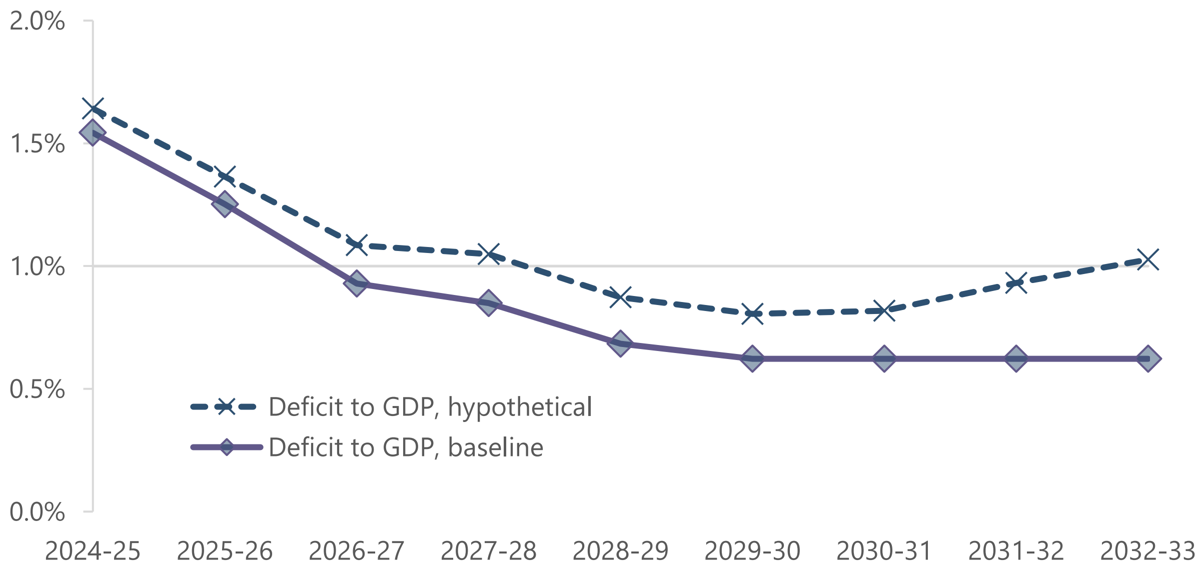
Impact on deficit-to-GDP ratio

Figure 3 compares the trajectory of the deficit-to-GDP ratio in both the hypothetical and baseline scenarios, highlighting their differing paths throughout the forecast period. The results indicate that meeting the fiscal objective of reducing the deficit-to-GDP ratio to below 1% by 2026-27, and maintaining a downward trajectory in subsequent years, may not be fully achievable.

In the baseline scenario, the deficit-to-GDP ratio is projected to fall below the 1% target in 2026-27 and continue declining over the next three years, reaching 0.62% in 2029-30 and then stabilizing at this level through to 2032-33.

In contrast, the hypothetical scenario shows a higher deficit-to-GDP ratio throughout the projection. Although it decreases initially, it only reaches 1.08% in 2026-27, failing to meet the 1% target. The ratio continues to decline over the following three fiscal years, reaching a low of 0.8%, but then rises steadily in the final years of the forecast, exceeding 1% in 2032-33. The increases in the last three years are attributed to the substantial rise in military spending necessary in the post-ONSAF period to achieve the 2% target by 2032-33.

Figure 3
Hypothetical forecast of deficit-to-GDP ratio versus baseline



Fiscal Year	Hypothetical	Baseline
2024-25	1.64%	1.54%
2025-26	1.36%	1.25%
2026-27	1.08%	0.93%
2027-28	1.05%	0.85%
2028-29	0.87%	0.68%
2029-30	0.81%	0.62%
2030-31	0.82%	0.62%
2031-32	0.93%	0.62%
2032-33	1.03%	0.62%

Source:
Office of the Parliamentary Budget Officer.

Note:
PBO calculations based on inputs from National Defence and other PBO works.

Notes

[1] Defence expenditures and NATO's 2% guideline. North Atlantic Treaty Organization, 2024. Accessed 10/04/2024.

[2] Statement for Defence Minister Bill Blair on Canada's work to reach the NATO defence investment pledge by 2032. Government of Canada, July 11, 2024. Accessed 10/04/2024.

[3] Total military expenditures, under NATO's definition, are inclusive of defence spending from government departments other than the Department of National Defence. A precise definition can be found on the NATO website.

[4] Addendum: National Defence Funding and Projected Canadian Defence Spending to GDP. Our North, Strong and Free: A Renewed Vision for Canada's Defence (ONSAF), Department of National Defence, Government of Canada, 2024. Accessed 10/04/2024.

[5] The defence expenditures reproduced in this table are inclusive of defence expenditures from ministries other than the Department of National Defence, such as the Canadian Coast Guard and Veterans Affairs, as is permitted under the NATO definition.

[6] Although the ONSAF addendum cites the OECD as the source for its GDP forecast, the cited projections only extend to 2025-26, and the ONSAF GDP figures for 2026-27 and beyond do not appear on the OECD website. OECD projections of Canadian GDP from the publication cited by DND (OECD Economic Outlook No. 114) are significantly higher than those cited in ONSAF and are similar to recent PBO projections. Accessed 10/04/2024.

[7] See note 4.

[8] To avoid ambiguity, NATO designates the year by which military spending is assessed as the year which includes the highest number of months. In Canada's case, the 2032 target year would then refer to the 2032-33 fiscal year.

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