

A REPORT OF THE CSIS
KISSINGER CHAIR, EUROPE
PROGRAM, AND DEFENSE-
INDUSTRIAL INITIATIVES
GROUP

A Diminishing Transatlantic Partnership?

THE IMPACT OF THE FINANCIAL CRISIS ON EUROPEAN DEFENSE
AND FOREIGN ASSISTANCE CAPABILITIES

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INTRODUCTION

Over the past five decades, the United States, its NATO allies, and other European Union countries have been partners in maintaining transatlantic security and leading contributors to international stability and economic development. As President Barack Obama wrote on the eve of NATO's November 2010 Lisbon Summit, the U.S. relationship with "our European allies and partners is the cornerstone of our engagement with the world and a catalyst for global cooperation."¹

This report explores the impact of the global financial crisis, and the subsequent European recession and sovereign debt crisis, on Europe's ability to sustain its valuable contributions to this partnership. It concludes that as the ongoing economic and political crisis deepens, Europe is likely to be a less capable, less willing, and less interested partner in those endeavors. Measures of this shift in burden sharing are already evident. As NATO Secretary General Anders Fogh Rasmussen noted at the 2011 Munich Security Conference, a decade ago the United States accounted for just under 50 percent of total Alliance defense spending. Today the U.S. share is closer to 75 percent and this transatlantic imbalance of defense effort and capabilities is projected to grow.² As the Secretary General also observed, some in Europe are not alarmed by this shift, because they are content with the EU's status as the leading provider of official humanitarian and development assistance. But this de facto division of labor that is emerging, where the United States takes on hard-power missions and Europe opts for soft-power tasks, will have a corrosive effect on the transatlantic relationship. Moreover, the analysis in this report suggests that the economic crisis is likely to result in a significant contraction of European soft power, as official development assistance budgets come under pressure from governmental austerity measures.

The report is divided into five chapters. It begins with a review of the evolution of the current economic and political context and a survey of major economic forecasts for Europe, as well as an assessment of the impact of these trends on the European Union. Chapter 2 offers an analysis of European foreign assistance budgets. The next two chapters explore the impact of economic trends on European military spending and capabilities and on defense industry. The last chapter considers the broader implications of these trends for the transatlantic partnership and ways to mitigate the effects of economic constraints in the European and transatlantic contexts.

1. Barack Obama, "Europe and America, Aligned for the Future," *New York Times*, November 18, 2010, <http://www.nytimes.com/2010/11/19/opinion/19iht-edobama.html>.

2. NATO Secretary General Anders Fogh Rasmussen, "Building Security in an Age of Austerity" (keynote speech, 2011 Munich Security Conference, February 4, 2011), http://www.nato.int/cps/en/natolive/opinions_70400.htm.



EXECUTIVE SUMMARY

The global financial crisis and the subsequent recession and sovereign debt crisis are having a profound impact on European and transatlantic affairs. Europe is likely to become a less-capable, -willing, and -interested partner of the United States in maintaining international security and promoting global growth. Over the next five years, defense capabilities will continue to decline, ambitious foreign assistance plans will be trimmed, and Europe's level of ambition will be tempered by the demands of getting its economic and political house in order.

A Perfect Economic Storm Hits Europe

- The fallout from the first wave of the global financial crisis in the fall of 2008 was somewhat delayed in Europe, but the effects of the second and third waves have created a perfect economic storm that has upended European finances and politics. These conditions have led to growing unemployment and social unrest, the fall of a number of governments, and increasing pressures to reduce discretionary governmental spending, including for defense and foreign assistance.
- Most forecasts project that the EU-27 will experience an average annual economic growth rate of 1.5 percent through 2013 with continuing risk of a double-dip recession and weak growth by historical standards through at least 2015. Mounting debt, which could grow from 80 percent of gross domestic product in 2010 to more than 100 percent of GDP by 2015 without policy changes, will also slow growth in the EU-27.
- Over the coming decade, many European countries will face severe macroeconomic imbalances, including large output gaps, high unemployment, wide fiscal deficits, and the need to exit from exceptionally loose monetary policy. Assuming a solution to the current sovereign debt crisis, Europe's *implicit debts* are even more worrisome. Demographic trends, which will result in an increase in the ratio of pensioners to taxpayers, will lead to a *sustainability gap*. Aside from the current crisis, demands on public resources to support aging populations are projected to cause GDP growth potential in the EU-27 to fall from 2.4 percent per year through 2020 to 1.7 percent per year in the following two decades.
- The uneven response by European policymakers to Europe's banking and sovereign debt crises has exacerbated the situation, leading to doubts about the future of the euro and the greater European project itself. The crisis has accelerated the fragmentation of Europe into three camps: (1) the core euro-zone countries that are strong economic performers; (2) the periphery euro-zone countries that perform poorly economically; and (3) the 10 EU members that remain outside of the euro zone for the foreseeable future. It is unclear how these three camps will maintain political unity as they confront starkly different economic conditions.

Foreign Assistance: Creative Accounting to Meet Goals

- Much of Europe's soft power leadership emanates from its official development assistance (ODA) as the European Union and its member states constitute the world's largest international aid donor. The 15 EU countries that are members of the Organisation for Economic Co-operation and Development (OECD) Development Assistance Committee (DAC) netted \$67.1 billion in ODA, or 56 percent of the DAC's total ODA in 2009. In 2009, the EU members' ODA total dipped slightly, representing 0.44 of gross national income (GNI). EU DAC members will fall short of their 2010 goal of 0.56 GNI and will be hard-pressed to reach the Millennium Development Goal of 0.7 percent by 2015.
- The sovereign debt crisis has accelerated pre-existing trends in European development assistance, including aid inflation, tied aid, and a move away from aid to least-developed countries and toward pre-EU accession countries, EU border states, resource-rich countries, and high-profile operations, such as Afghanistan.
- But the ODA story in Europe is not a consistent one. Europe's sovereign debt crisis has produced three categories of European aid donors: (1) "periphery" countries most affected by the crisis that are being forced to cut robust ODA as part of overall austerity programs, such as Ireland; (2) the "core" countries that have fared relatively well in the crisis and are maintaining their (differing) assistance commitments, such as the United Kingdom and Germany; and (3) some "outlier" countries that fared well in the crisis but are either reducing assistance, emphasizing tied aid, or reclassifying some peacekeeping and security support programs as ODA in the face of diminished public support, such as the Netherlands and Poland.
- Maximizing efficiency will become the mantra for European ODA. As ODA budgets grow politically less palatable, European politicians and development officials will increasingly seek to link aid to good governance and to stop funding programs at the first sign of inefficiencies. It is unclear whether Europe's drive for efficiency will overshadow the need for greater effectiveness of the aid itself and whether it can strike a rational division of labor with the United States and other leading donor countries.

Outlook for Defense: Doing Less with Less?

- Most European defense budgets have been cut less deeply than other sectors of European governmental spending in 2010–2011 because they are protected by Alliance commitments, contractual obligations, and industrial concerns. This is not sustainable. Tight fiscal circumstances over the next five years will require cuts in force levels, capabilities, and readiness, as well as deferred procurements, further eroding overall European military capabilities already suffering from two decades of underinvestment.
- European governments have undertaken major reductions in their force structures, and defense spending has been flat or slightly declining over the past two decades. Two contrasting trends are evident:

- ▶ Total defense spending among 37 European countries examined has fallen from €251 billion to €218 billion between 2001 and 2009.
- ▶ Per-soldier spending in these countries has *increased* from slightly above €73 thousand to more than €91 thousand during the same period, with a relative shift of spending toward equipment and operations and maintenance and away from personnel and infrastructure.
- These trends suggest a *possible* movement within European armed forces toward replacing quantity with quality and an increasing willingness to invest in the immediate modernization of the capabilities of those forces. If stable and efficient defense spending proves elusive over the next five years, further force reductions would be required to maintain the momentum toward more capable forces.
- While costs of current operations, particularly for Afghanistan, have grown significantly, they have been sustained by extra-budgetary funding in many European countries. The continued availability of extra-budgetary funding is highly questionable. Where operations are funded from defense budgets, their costs have diminished resources in other accounts, limiting force structure and modernization.
- While operations in Afghanistan have advanced the transformation of European forces and made them more expeditionary, the readiness, equipment, and training of forces not involved in those operations is likely to continue to erode. Moreover, the political will to undertake extended expeditionary operations is being undermined by economic constraints and operational fatigue. European governments are already suggesting that future NATO crisis response operations should be “in and out” operations with explicit exit strategies.
- Fiscal constraints are likely to impede realization of NATO’s Lisbon Summit Capabilities Package. There is considerable uncertainty about the ultimate costs and about what part of those costs European governments are prepared to provide for the development of a comprehensive NATO missile defense system.
- The actions taken by the three most capable European NATO allies—the UK, France, and Germany—will be determinate. The three represent 65 percent of all defense expenditure in NATO Europe and 88 percent of all research and technology investment.
- ▶ The 2010 UK Strategic Defence and Security Review (SDSR) calls for 8 percent cuts in defense spending over the next four years and then levels off, but further cuts after 2014 are likely. The UK will be less able to undertake unilateral joint military operations but will retain enough conventional military capability to be the lead coalition nation in a small-scale foreign contingency or make significant contributions to a U.S.- and/or NATO-led mission. The UK is committed to maintaining a self-supporting brigade-sized force (6,500) capable of being deployed anywhere in the world and sustained indefinitely.
- ▶ The 2008 French White Paper on defense had already called for sharp reductions in the number of French forces from 270,000 to 225,000 with corresponding budget cuts over the subsequent six to seven years. The 2011 budget plan calls for a further 3 percent reduction in defense spending through 2013. Paris is committed to being in a position to simultaneously field 30,000 soldiers deployable within 6 months for a period of one year for a major operation, a 5,000-strong reserve on permanent operational alert, and up to 10,000 troops available for territorial defense.

- ▶ In Germany, a major reform effort to abolish conscription and cut troop levels from 250,000 to 180,000 once appeared to be on track to provide a promising example for other European countries with similar force structures. However, the difficulties of pursuing a comprehensive force overhaul in times of financial distress is becoming more and more apparent. The reform efforts may be at risk and while they could enhance overall readiness and effectiveness of the Bundeswehr, a number of acquisition cuts will further constrain capabilities for high-end operations. The percentage of German forces that are deployable and sustainable is quite low compared to other NATO countries, but there is some support for increasing the number of rapidly deployable, high-quality forces for expeditionary missions from 7,000 to 10,000 or 15,000.
- Given these trends among the big three, and limited spending by other allies, NATO Europe will make only marginal improvements in capabilities to undertake various missions absent significant restructuring and defense integration. Most other allies will probably be able to contribute no more than a battalion to future expeditionary operations. In the naval domain, allies will be able to contribute limited numbers of surface combatants for sea control, maritime security, and humanitarian operations, but reduced force levels will constrain operational flexibility and global presence. Air forces will suffer from aging aircraft and declining readiness.

A Healthy, Diversified Defense Industry despite Declining European Demand

- The European defense and security industrial base has the capacity to develop and produce a wide range of equipment and services, including transformational and operationally relevant ones such as counter-IED (improvised explosive device) capabilities, deployable logistics, C4ISR (command, control, communications, computers, intelligence, surveillance, and reconnaissance), and cyber and missile defense. This capacity exists because European companies have recognized that developing such technologies is important to their competitive position in both defense and commercial markets around the world.
- The European defense and security industrial base overall remains capable, competitive, and financially healthy, but it is facing the challenge of managing anticipated further declines in European defense spending. European defense and security companies have performed well in recent years, both in absolute terms and compared to their peers in the commercial sector. Aided by protected defense equipment accounts, higher domestic security spending, and increased defense business abroad, their revenues grew steadily despite falling or stagnant European defense spending. In addition, many European defense and security companies have significant commercial business units, which can potentially be enhanced to offset declines in the defense business.
- It is unlikely that these trends will continue at a pace that can offset future reductions in defense spending. Furthermore, U.S. defense modernization accounts are likely to fall in the near future. The growth potential of other regional markets over the next five years might also change. For instance, the revolutionary tendencies in the North African region might shift acquisition priorities and preferences for suppliers. Given the constraining budget environment on both side of the Atlantic, and the low barriers for European firms to exit the defense business, it will be critical for European governments to communicate their requirements clearly to

European defense and security companies so that these in turn may most effectively align their portfolios with their customers' priorities.

Mitigating the Impact of the Crisis on the Transatlantic Partnership

- Most European governments are pursuing defense reforms and reductions on a purely national basis driven heavily by resource constraints with little or no reference to NATO or EU obligations. This could result in significant shortfalls and loss of key military capabilities.
 - ▶ The NATO Defense Planning Process (NDPP) is too cumbersome and diffuse to manage and shape the ongoing reforms and reductions in national defense programs. Another NATO mechanism, separate from but linked to the NDPP, might be established to ensure the overall coherence of the residual collective Alliance defense posture as member governments implement various reforms and reductions.
- As European governments struggle to preserve critical defense capabilities in this era of austerity, some have suggested there is a “cooperative imperative” that could overcome well-known challenges in this area. NATO defense ministers have recently directed Allied Command Transformation to lead a task force to promote and synchronize ideas for multinational capability development. Pooling and sharing of capabilities, multinational procurement programs, and role specialization have been tried before with some success, but many more such efforts have proved disappointing, with often-higher costs than systems developed on a national basis. Potential cooperation among European governments must take into account the heterogeneity of their forces on three levels: varying capabilities, threat perceptions, and levels of ambition.
- The appeal of multinational collaboration in defense research and development and acquisition is strong. Cost savings through economies of scale, better capabilities through knowledge sharing and integration, common logistics, improved interoperability, and stronger political ties constitute convincing arguments in favor of collaboration. Practical experience has not met these expectations. Most multinational collaborative defense programs have focused on large, expensive, and platform-based systems. Shifting the focus away from large platforms with long development periods toward smaller-scale programs in emerging, more operationally relevant domains may yield better results and draw new players into the defense business.
- The current austerity measures have placed earlier British and French defense plans and models of defense cooperation in jeopardy. To maintain their relevance and global reach, the British and French concluded a Defence Co-operation Treaty in 2010 and a package of joint defense initiatives. The outcome of these initiatives between the two most capable European powers is likely to shape the future of European defense capability, because the success or failure of the initiatives will influence British and French thinking on the potential development of the Lisbon Treaty's Permanent Structured Cooperation.
- Increased defense integration among other groups of European countries including the Weimar Group, Nordic and Baltic states, and the Visegrád Group have also been undertaken outside the scope of the EU's Common Security and Defence Policy (CSDP), but offer practical

steps toward enhancing capabilities and maximizing use of defense resources among like-minded EU members.

- Even before the 2008 financial crisis took hold, France and other key European governments appeared to have diminished ambitions for the CSDP, content not to push it beyond short-term crisis management operations at the low end of the Petersberg tasks. As EU governments grapple with the current economic and political crisis and Union High Representative Catherine Ashton focuses on development of the External Action Service, it seems likely that 2010 Headline Goals for the CSDP will not be met anytime soon.
- The joint Swedish-German Ghent Initiative offers some promise for EU pooling and sharing and capability development. It identifies three tiers of potential collaboration. It proposes to give European member states the ability to decide which capabilities will remain strictly sovereign while retaining the flexibility to move forward in less politically sensitive areas. Further, it gives individual governments the ability to identify adequate partners for cooperation in specific areas and gives the European Defence Agency (EDA) and other relevant EU bodies a role in facilitating coordination and identifying any potential opportunities for linking various initiatives. While this construct is practical, its implementation is likely to encounter familiar hurdles.
- Europe has honed its international development leadership skills in exercising the full range of its soft power. But as the reality of austerity measures and lackluster economic growth ultimately reduce European ODA, aid priorities will be limited and more directly tied to a country's economic or strategic interests.
 - ▶ As European and American foreign assistance budgets receive closer political scrutiny from parliaments and the U.S. Congress during times of greater austerity, there will be increasing pressure to maximize administrative efficiencies as well as develop enhanced transatlantic assistance collaboration and cooperation.
 - ▶ Moving forward, it will be essential to closely engage the private sector in a significant collaborative effort with the public and nongovernmental development actors in order to leverage an increasingly diverse development space.
- With a healthy defense industrial base, a cadre of operationally experienced military forces, its status as a world leader in soft power, and the prospect of greater policy coherence under the Lisbon Treaty, Europe has the tools required to play a larger role in world affairs. How European governments respond to the economic crisis and the changing demands of global leadership will reveal a great deal about their cohesion and commitment to the European project and a fuller transatlantic partnership.

1

A PERFECT ECONOMIC STORM HITS EUROPE

Stephen J. Flanagan, Heather A. Conley, and
Alessandro Scheffler

The Waves of Crisis 2008–2010

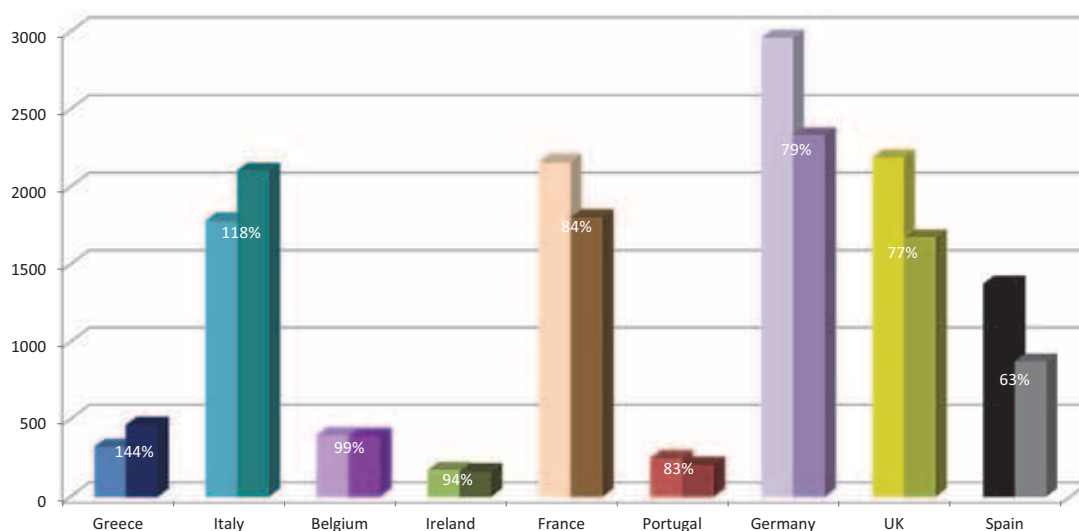
The fallout from the first wave of the global financial crisis in the fall of 2008 was somewhat delayed in Europe, but the impact of the second and third waves has created a perfect economic storm that has upended European politics and finances. Since May 9, 2010, when it was forced to rescue the Greek economy, the European Union has struggled to develop a durable response and define a mechanism that will ultimately resolve the crisis. The uneven response by European policymakers to the banking and sovereign debt crises on the Continent has exacerbated the situation, leading to doubts about the future of the euro and the greater European project itself. The crisis will continue to profoundly reshape Europe politically and economically over the next decade, with major implications for NATO and other elements of the transatlantic partnership.

In the short term, the European economic crisis has accelerated the fraying of intra-European coordination (e.g., Franco-German) and consolidation (e.g., EU enlargement policy) as Europe begins to fragment into three camps: (1) the core eurozone countries that are strong economic performers, (2) the periphery eurozone countries that perform poorly economically, and (3) the 10 EU members that remain outside of the eurozone for the foreseeable future. It is unclear how these three camps will maintain their political unity and consensus as they confront starkly different economic conditions. If “core” Europe eventually emerges as a stronger and more efficient economic and political actor under German leadership, this “core” may be less willing to maintain its defense posture as it increasingly relies on American hard power, more self-interested in promoting its global economic interests, more concerned about maintaining its industrial base than providing overseas development assistance, and more focused on pursuing policies that may or may not align with or complement those of the United States.

While the short-term negative impact of the sovereign debt crisis is daunting, there may be some long-term benefits to this economic storm. Europe has been given an opportunity to attempt to correct the fatal structural flaws of its monetary union, reorient its toothless Stability and Growth Pact, construct a fiscal and economic union, and begin to tackle long-overdue structural reforms. Under the best of political and economic circumstances, this reform process would be long and difficult to undertake. Under today’s strained circumstances, it will take much longer and be more painful, and the outcome more uncertain.

The most prominent economic effects of the crisis have been unsustainable debt-to-GDP ratios, sustained negative or anemic growth, mounting youth unemployment, “brain drain” emigration, pressure from an influx of immigration from North Africa and the Middle East, and social unrest. The cost of the remedies have snowballed, with joint EU-International Monetary Fund loans of €110 billion for Greece, €85 billion for Ireland, and a possible increase in the loan capacity of the €440 billion European Financial Stability Facility (EFSF). Less than a year after receiving their bailout packages, Greece and Ireland already have signaled that the conditions of their agree-

Figure 1. Public Debt as a Percentage of National GDP (2010 estimated)



Note: Data based on purchasing power parity (PPP) calculation.

Source: CIA, *The World FactBook*, see <https://www.cia.gov/library/publications/the-world-factbook/rankorder/2186rank.html>, and <https://www.cia.gov/library/publications/the-world-factbook/rankorder/2001rank.html> (both accessed April 15, 2011).

ments are unsustainable. Many investors and analysts believe the restructuring of Greece's public debt, which Greek, EU, and IMF officials have all discounted, is simply inevitable. Only after weeks of agonizing debate and at German insistence, the EU agreed on December 17, 2010, to amend the Maastricht Treaty and create a new, post-2013 European Stability Mechanism of undefined size backed by unspecified sanctions to safeguard the financial stability of the 17-member eurozone. It is unclear how each signatory will amend the treaty and whether it will trigger referenda movements in several European countries. With the recent introduction of the "Euro Plus Pact," there is no European consensus on how to achieve greater fiscal harmonization or whether the healthier economies are willing to jeopardize their triple-A credit rating for the sake of the periphery.

For many European countries, debt levels are projected to continue to increase substantially compared to the pre-crisis situation.¹ While in 2007 general government deficits corresponded to less than 1 percent of GDP in the EU-27, they reached more than 7 percent in 2010 before beginning to shrink in 2011. Debt ratios have also spiked sharply. EU-27 debt corresponded to 59 percent of GDP in 2007, while it reached levels near 80 percent in mid-2010 (see figure 1). Debt

1. Historical antecedents show that banking crises have produced a significant and long-lasting increase in government debt-to-GDP ratio, with the effect being a function of the severity of the crisis. In particular, for severe crises, comparable to the current one in terms of output losses, the government debt ratio is found to have increased by up to 50 percentage points at the peak and by 37 percentage points in the medium term (eight years after the onset of the crisis). For further information, see Davide Furceri and Aleksandra Zdzenicka, *The Consequences of Banking Crises for Public Debt*, Working Paper No. 801, OECD Economics Department, pp. 5–6.

projections show that on a no-policy-change scenario, average debt in the EU will rise well above 100 percent of GDP by 2015 and exceed 130 percent of GDP by 2020.² Many advanced economies already face high public debt funding needs as primary balances remain in deficit and short-term debt issued during the financial crisis matures over the next year and a half. The debt has now reached levels at which consolidation would require constant surpluses of about 4 percent per year, and responsible fiscal adjustments combined with an optimistic scenario of 2 percent growth rates will show their effect only after 2015. The magnitude of the fiscal retrenchment required for short-term constraint of public debt would create significant risks of relapsing into deep recession.

Medium-term and Long-term Outlooks

With its activities concentrated on Europe, the IMF maintains that a strong and credible fiscal consolidation effort is required as long as the austerity measures are designed to minimize the negative impact on growth and employment.³ Unfortunately, announced austerity programs alone may not be enough to secure credibility in fiscal consolidation, as uneven strategies are being implemented across Europe. Fiscal consolidation efforts in some countries have been front-loaded and accelerated, but fundamental structural adjustment programs have yet to be implemented in others.⁴

Over the coming decade, many European countries will face severe macroeconomic imbalances such as large output gaps, high unemployment, wide fiscal deficits, and the need to exit from exceptionally loose monetary policy.⁵ Post-boom periods accompanied by the correction of current account and competitiveness imbalances tend to be particularly costly from a growth and budgetary point of view.⁶ Europe's medium-term prospects face serious headwinds, as countries will continue to be plagued by weak fiscal sectors, waning growth effects from fiscal and monetary stimulus, and a pressing need to set public finances on a sustainable path.⁷

Official forecasts by the EU, OECD, and IMF project the EU-27 will experience economic growth somewhere around 1.5 percent until 2013 as significant downward risks and the continuing peril of a double-dip recession loom. The recent weak recovery has relied on increased demand in emerging markets, inventory restocking, and financial stimulus for growth as global trade rebounded in 2010 to pre-crisis levels.⁸ Most forecasts predict, however, that with reduced demand in the developed economies, particularly in Europe, and possible implementation of protectionist measures, global trade growth will remain well below the peak years of globalization (2003–2007) through 2015.

2. European Commission, Directorate General for Economic and Financial Affairs, *Public Finances in EMU—2010*, European Economy 4, 2010, pp. 1-2, http://ec.europa.eu/economy_finance/publications/european_economy/2010/pdf/ee-2010-4_en.pdf.

3. International Monetary Fund (IMF), *Regional Economic Outlook: Europe—Building Confidence*, World Economic and Financial Surveys, October 2010, p. 7, <http://www.imf.org/external/pubs/ft/reo/2010/eur/eng/ereo1010.pdf>.

4. Organisation for Economic Co-operation and Development (OECD), *OECD Economic Outlook*, No. 87, June 2010, p. 6, <http://www.oecd.org/dataoecd/19/25/45276395.pdf>.

5. OECD, *OECD Economic Outlook Preliminary Edition*, May 2010, p. 232, <http://www.oecd.org/dataoecd/19/25/45276395.pdf>.

6. European Commission, *Public Finances in EMU—2010*, p. 7.

7. World Bank, *Global Economic Prospects: Fiscal Headwinds*, June 2010, p. 5, <http://siteresources.worldbank.org/INTGEP2010/Resources/FullReport-GEPSummer2010.pdf>.

8. As evidenced by the dynamism in the manufacturing sector for outreaching services.

If European domestic spending is to play a role as an engine of growth, confidence among investors and consumers will need to increase and European banks, particularly the regional lending institutions such as the German Landesbanks, must stabilize. However, current and future austerity measures, as well as a limited supply of credit, will constrain economic growth. Although fiscal austerity measures may have prevented the European economic situation from deteriorating when market pressures were at their most intense, this austerity, combined with elevated interest rate spreads exacerbated by rising food and energy costs, will likely slow if not curtail growth.⁹ Finally, a sharply contracting European labor market (the result of demographic trends) and increasing pension and health care costs will also weigh on European economic growth in the long term.¹⁰

Over the longer term, assuming a solution to the debt crisis, Europe's *implicit debts* are even more worrisome than current sovereign debts. *Implicit debts* are the difference between what states have promised to citizens in the future and the expected sum of future taxes and contributions. Particularly worrisome in this regard are demographic trends, featuring both slow birthrates and longevity. This results in an increase of the number of payees against payers, leading to a *sustainability gap*. On average, European implicit debt is at 211 percent of GDP and 2 percent of current debt, an unsustainable figure in virtually all European countries. As outlined by Asghar Zaidi, the policy issues created by aging populations are "relatively more latent and covert, and exert significant additional demands on future budgets. . . . The current adverse budgetary position combined with long-term demands on public resources generated by the ageing of populations will present significant fiscal challenges throughout the EU."¹¹

In fact, the labor market will act as a drag on growth and per capita income starting from the 2020s. The European Commission's *2009 Ageing Report* assumes that the average potential growth rate in the EU-27 will fall from 2.4 percent per year through 2020 to 1.7 percent per year in the following two decades.¹² The OECD has estimated the aging-induced drag on GDP per capita in France and Germany will average -0.2 to -0.3 percentage points of growth per annum during the next half century.¹³ Prior to the crisis, a sharp decline in the annual average potential GDP growth rate was projected in the EU, from 1.6 percent in the period 2021–2030 to 1.3 percent in the period 2041–2060.¹⁴ In addition to falling potential GDP growth rates, the sources of growth will alter dramatically. The labor input will make a positive contribution to growth in both the EU and the eurozone up to 2020, but turn significantly negative thereafter. Over time, productivity and technological innovation will become the dominant source of growth.¹⁵

9. IMF, *Regional Economic Outlook: Europe—Building Confidence*, p. 3.

10. Uri Dadush and Bennet Stancil, "Europe's Long-Term Growth Prospects," *International Economic Bulletin*, October 8, 2010, Carnegie Endowment for International Peace, http://www.carnegieendowment.org/publications/index.cfm?fa=view&id=41695&zoom_highlight=europe+growth.

11. Asghar Zaidi, "Fiscal and Pension Sustainability: Present and Future Issues in EU countries," Policy Brief, February 2010, European Centre for Social Welfare Policy and Research, p. 2, http://www.euro.centre.org/data/1267020891_76093.pdf.

12. European Commission, Directorate General for Economic and Financial Affairs, *2009 Ageing Report: Economic and Budgetary Projections for the EU-27 Member States (2008–2060)*, European Economy 2, 2009, p. 23, http://ec.europa.eu/economy_finance/publications/publication14992_en.pdf.

13. Quoted in European Commission, *The Economic Impact of Ageing Populations in the EU25 Member States*, Economic Paper No. 236, December 2005, p. 15.

14. European Commission, *2009 Ageing Report*, p. 70.

15. *Ibid.*, p. 73.

The EU-27 currently devote just over 10 percent of their combined gross domestic product to pensions, while health care and long-term care currently account for 7.9 percent of GDP.¹⁶ While these rates are already concerning to officials across the EU, a recent CSIS analysis estimates that some major EU countries including France and Italy will be spending around 20 percent of their GDP on health and long-term care for seniors as soon as 2020.¹⁷ Potential offsetting savings in education and unemployment benefits are likely to be very limited. To avoid a collapse of Europe's social systems, reforms will have to be implemented in the next few years. As the EU's *2009 Ageing Report* outlines, there is still a window of opportunity—a period of about 10 years during which labor forces will increase—for implementing the structural reforms needed by aging societies.¹⁸

Considering all these challenges, economic growth in Europe will remain weak by historical standards over at least the next five years. In part, this is due to the lingering impact of the crisis and the accelerating fiscal adjustment in 2011. But it also reflects well-known structural rigidities in the labor, product, and services markets and potentially an uptick in inflation that will limit the eurozone's potential growth now that the depletion of the inventory cycle has run its course.¹⁹ The mere scale of the recession and the weakness of the recovery will not allow the output gap to be closed before 2015. The high levels of unemployment/reduction of the labor force and the hang-over in financial markets will continue to drag growth.

These factors have been increasingly influential in shaping recent forecasts. Although economic scenarios like “lost decade” and “permanent shock” were previously treated as “worst-case,” it appears that these are now becoming increasingly true. The OECD calculates that 3 percent growth potential has fallen victim to the crisis. However, even if a return to the natural level of output is achieved after 2015, this is likely to be at a lower level than expected. As the *Economist* describes, “faster growth is not a silver bullet. It will not eliminate the need to trim back unrealistic promises to pensioners; no rich country can simply grow its way out of looming pension and health-care commitments. Nor will it stop the relentless shift of economic gravity to the emerging world.”²⁰

Although the OECD still expects actual and potential output as well as unemployment and structural unemployment to align by 2015, the growth rate of OECD-wide²¹ potential output is projected to average only about 1.9 percent per annum. This is well below the average growth rate of 2.3 percent per year achieved over the seven years preceding the crisis. Most of this decline is due to slower growth both in participation rates and in the working-age population, mainly reflecting demographic trends rather than additional effects of the crisis.²² In the medium term, the main risk is therefore that fiscal and competitiveness imbalances in peripheral economies and insufficient action to tackle weak banks could lead to a protracted period of subpar growth and

16. By 2050, pension costs are projected to rise by an additional 2.2 percent. Health care, which currently accounts for 6.4 percent of GDP, will rise by an additional 1.6 percent. The share of combined age-related public expenditures will grow by 3.4 percent of GDP by 2050 and 4.75 percent by 2060. European Commission, *2009 Ageing Report*, pp. 22–26.

17. Richard Jackson, *The Global Aging Preparedness Index* (Washington, D.C.: CSIS, October 2010), p. 14, http://csis.org/files/publication/101014_GlobalAgingIndex_DL_Jackson_LR.pdf.

18. European Commission, *2009 Ageing Report*, p. 32.

19. IMF, *Regional Economic Outlook: Europe—Building Confidence*, p. ix.

20. *Economist*, “How to Grow,” Special Report, <http://www.economist.com/node/17173886>.

21. Separate OECD estimates of the EU-27 potential output were not available at time of publication.

22. OECD, *OECD Economic Outlook Preliminary Edition*, p. 237.

occasional crises.²³ While the current economic stagnation is not expected to affect potential growth in the longer term (beyond 2025), growth is nevertheless expected to slow for other structural reasons (mainly demographics).²⁴

These difficult economic conditions have led to growing unemployment and social unrest in Europe, the fall of a number of governments, and increasing pressures to reduce discretionary governmental spending, including spending for defense and foreign assistance.

23. IMF, *World Economic Outlook (WEO): Recovery, Risk, and Rebalancing*, World Economic and Financial Surveys, October 2010, p. 74, <http://www.imf.org/external/pubs/ft/weo/2010/02/index.htm>.

24. OECD, *OECD Economic Outlook Preliminary Edition*, p. 239.

2

FOREIGN ASSISTANCE

CREATIVE ACCOUNTING TO MEET GOALS

Heather A. Conley

Overview by the Numbers

Much of Europe's soft-power leadership emanates from its official development assistance (ODA). The European Union and its member states constitute the world's largest international aid donor. The 15 EU countries that are members of the Organisation for Economic Co-operation and Development (OECD) Development Assistance Committee (DAC) netted \$67.1 billion in ODA, or 56 percent of the DAC's total ODA in 2009. If the \$13.4 billion of ODA from EU institutions is added, the European total for 2009 is \$80.8 billion or 67.3 percent of the DAC total.¹ In comparison, the United States government provided \$28.7 billion in ODA, 23 percent of the DAC total in the same year—although foreign assistance from private U.S. sources is even larger than U.S. ODA.² In 2005, EU countries committed to raising their percentage of gross national income (GNI)³ dedicated to aid to a collective total of 0.56 percent in 2010 and to 0.7 percent by 2015. But Europe's sovereign debt crisis has called its bold assistance goals into question. Reductions in GNI coupled with some "creative" development assistance budgetary accounting (or aid inflation) by European capitals are a cause for concern that Europe's professed faith in its enduring soft power faces defined limits in an age of austerity. In 2009, the EU DAC members' ODA total dipped slightly (0.2 percent), representing 0.44 of GNI. The OECD Secretariat estimates that the EU members will fall well short of their 2010 goal, probably reaching only 0.48 percent of GNI, when the data become available later in 2011.⁴

1. Organisation for Economic Co-operation and Development (OECD), "Development Aid Rose in 2009 and Most Donors Will Meet 2010 Aid Targets," April 14, 2010, http://www.oecd.org/document/11/0,3343,en_2649_34487_44981579_1_1_1_1,00.html; OECD, "Table 1, DAC Members' Net Official Development Assistance in 2009," <http://www.oecd.org/dataoecd/52/9/41808765.xls>.

2. According to the U.S.-based nongovernmental organization Interaction, "Private aid flows to developing countries have increased significantly in recent years. This represents a significant change to the architecture of global aid, which has long been dominated by governments. Worldwide, private aid totaled at least \$49 billion in 2007, almost half the amount provided as official development assistance. Domestically, funding from private aid actors—including foundations, corporations, NGOs, universities and religious organizations—actually exceeded U.S. government assistance that year, \$33.4 billion compared with \$21.8 billion." <http://www.interaction.org/private-aid-flows>.

3. "Gross national income (GNI) is GDP less net taxes on production and imports, less compensation of employees and property income payable to the rest of the world plus the corresponding items receivable from the rest of the world (in other words, GDP less primary incomes payable to nonresident units plus primary incomes receivable from nonresident units)." Gross National Income (GNI), *Glossary of Statistical Terms*, March 5, 2003, <http://stats.oecd.org/glossary/detail.asp?ID=1176>.

4. OECD, "DAC Members' Commitments and Performance: Summary Table of OECD Secretariat Projections," April 2010, <http://www.oecd.org/dataoecd/17/12/44981982.pdf>.

But the ODA story in Europe is not a consistent one. The following analysis will explore the impact of Europe's sovereign debt crisis on three categories of active European aid donors: the periphery (those countries most affected by the crisis itself), the core (those European countries that have fared the crisis), and the outliers (those European countries that were not dramatically affected by the crisis but are exhibiting unique donor behavior). From the periphery, Ireland will be examined as an example of a small country that, in the past decade, has punched significantly above its economic weight relative to per capita ODA spending but, due to the crisis, has had to make significant reductions in its ODA budget. For the core, the United Kingdom and Germany will be examined as two very different approaches to ODA spending during times of voluntary austerity. Lastly, Poland and the Netherlands will be explored as outliers, as both countries are implementing very different ODA budgetary approaches. Finally, this chapter will assess the appearance of several distinct and emerging trend lines related to European ODA and what they portend for future European aid commitments and implementation.

The Periphery: Ireland

Over the past decade, Ireland has focused substantially on becoming a “soft power” leader within the EU: in 2008, Ireland was ranked fifth among the most generous EU donor members in percentage of ODA/GNI and was considered the “seventh most generous donor in the world in per capita terms.”⁵ But the economic crisis has taken a significant toll on Ireland. In 2009 the country reduced its ODA budget by €224 million—a 24 percent reduction and a greater percentage cut than was made to any other area of spending.⁶ When examining the 2011 ODA budget, it appears that although the Irish will remain on target at 0.52 percent GNI, the country will miss its 2015 EU and international target of 0.7 percent GNI.⁷ Importantly, approximately 80 percent of Irish aid is destined for sub-Saharan Africa, home to seven of its designated nine priority countries.⁸

It is unclear how much of the 2011 Irish ODA budget will ultimately be cut, but news accounts suggest that Ireland's National Recovery Plan anticipates a further reduction of €35 million.⁹ Perhaps the Irish government is making these budgetary adjustments out of both necessity and in response to shifting public sentiment. Traditionally there has been robust popular support in Ireland for international aid; an EU Commission survey found that 92 percent of those surveyed felt assisting people in the developing world was “important” or “very important,” with 65 percent of those polled saying that Ireland should meet or exceed its aid commitments.¹⁰ But a more recent opinion poll showed that half the Irish population believed a reduction in the development budget was in order, and a leading private sector official has expressed his desire for Ireland to abolish its development program completely.

5. Dóchas Budget 2010 submission, http://www.dochas.ie/Shared/Files/1/Dochas_Budget_submission_2010.pdf; “Minister Refuses to Rule Out Further Aid Cuts to Aid Budget,” *Irish Times*, September 7, 2010, <http://www.irishtimes.com/newspaper/ireland/2010/0907/1224278366705.html>.

6. Dóchas Budget 2010 submission.

7. John Gormley, “Speech on Budget 2011,” December 8, 2010, http://www.greenparty.ie/news/latest_news/john_gormley_s_speech_on_budget_2011.

8. “Minister Refuses to Rule Out Further Aid Cuts to Aid Budget.”

9. Kieran Cuddihy, “Ireland Still on Target, Despite Budget Cuts,” European Journalism Centre, Young Reporters Against Poverty competition, December 7, 2010, http://platform.youngreporters.net/post/ireland_still_on_target_despite_budget_cuts.

10. Dóchas Budget 2010 submission.

The Core: United Kingdom and Germany, A Case of Contrasts

As Irish ODA declined in 2009 the UK recorded the largest percentage increase in ODA in real terms at 14.6 percent.¹¹ For the moment, there appears to be political unanimity among Labour, the Conservatives, and the Liberal Democrats to ensure the UK remains on course to increase its development aid to 0.7 percent of GNI by 2013, as was confirmed in the release of the UK's Comprehensive Spending Review. However, not simply taking a handshake for granted, there is an attempt to make the 0.7 percent commitment legally binding on future governments beginning in 2013.¹²

According to a budget announcement last fall by the UK's Department for International Development (DFID), its ODA account had been "ringfenced," meaning that the resource and capital spending budgets for the DFID not only would be protected from spending cuts but would increase by 35 percent. However, like all governmental departments, DFID was not spared when it came to identifying administrative efficacy-cut opportunities and DFID's administrative budget will be reduced by 33 percent by the year 2014–2015.¹³

Although DFID continues to adjust to new budget realities, we are observing several trends that other Western donors are likely to follow closely in the coming months. In its pursuit of "maximizing efficiencies," DFID has appointed a new Independent Commission on Aid Impact that will conduct an assessment of all of its ODA spending; it will redirect funds from low-priority projects to those that specifically combat poverty and focus on Millennium Development Goals (MDGs); and it has announced that it will end aid programs to China and Russia. As DFID focuses and fine-tunes its programmatic activities, it is also being urged to maximize its work as a contribution to British national security and to focus on projects in Afghanistan, Pakistan, and other fragile states as well as engage in climate adaptation activities (£2.9 billion will be spent for international climate financing).¹⁴

Simply put, the UK is the international standard for its unwavering commitment to ODA. Over the past decade, the UK has tripled its ODA spending in real terms—making it the world's fourth-largest aid donor—and it is the G8 leader in delivering on its aid commitments.¹⁵ One of its most critical commitments is to Africa: DFID has increased its aid from £1.3 billion (2004) to £3.4 billion (2010).¹⁶ So, the question begs: can the UK maintain its clear commitment during a period of economic uncertainty, low consumer confidence, and lackluster economic growth? On the one hand, British think tanks have argued strongly against a return to the UK's development policy of

11. OECD, "Development Aid Rose in 2009."

12. OECD, *Development Assistance Committee (DAC), Peer Review: The United Kingdom*, 2010, p. 85, <http://www.oecd.org/dataoecd/49/20/45519815.pdf>; Bond, "UK Aid," in "EU Policy, Issues and Themes, Aid," <http://www.bond.org.uk/pages/aid.html>.

13. Department for International Development, "Spending Review 2010," October 20, 2010, <http://www.dfid.gov.uk/Media-Room/News-Stories/2010/Spending-review-2010/>.

14. Ibid.

15. Kevin Watkins, *Building on the Inheritance: The UK's Role in Global Poverty Reduction* (London: Chatham House, August 2010), p. 2, http://www.chathamhouse.org.uk/files/17140_bp0810_watkins.pdf.

16. "Annex Five: G8 Member Reporting, Aid and Aid Effectiveness," *Muskoka Accountability Report: Assessing Action and Results against Development-related Commitments*, January 2010, http://canadainternational.gc.ca/g8/assets/pdfs/mar_annex51.pdf.

the 1990s, which was largely a tied-aid affair (aid linked to domestic goods and services) principally managed by the Foreign and Commonwealth Office.¹⁷ Today, the UK stands as an international development leader in terms of identity, global strategy, and funds. It is likely that in the near term budgets will be protected—perhaps with a more robust defense of its ODA programs as being a vital element of the UK's national security—while administrative and personnel costs will be reduced to the bare minimum.

As a member of the G8 with a robust economy, Germany could easily be assumed to be as committed to its soft-power image as the UK is, yet Berlin lacks a clear development vision. In real terms, German ODA fell by 12 percent in 2009 due in part to Germany's decision to reduce debt relief to developing countries, which outweighed its increase in bilateral aid.¹⁸ Germany is one of the few countries (with Ireland, Italy, Austria, Greece, Slovakia, and Portugal) where ODA has decreased in both absolute and percentage terms.¹⁹ In 2009, Germany spent only 0.35 percent of its GNI on ODA, falling short of its promise to raise its percentage to 0.51 percent by 2010.²⁰ Aid groups have denounced German ODA policy as one that consistently fails to pull its weight and that has fallen prey to aid inflation. Germany's ODA budgetary increase in 2010, which was primarily used for climate change adaption and Afghanistan, has been significantly lower than expected.²¹

German ODA has primarily targeted politically strategic countries including Afghanistan, China, Egypt, and India, but at the same time Germany has also gradually begun to focus on sub-Saharan Africa.²² Despite its shift in aid to poor countries, Germany's 2009 ODA resources increased by only \$79 million, which, on its current trajectory, means Germany will meet only 25 percent of its Gleneagles commitment for aid to Africa.²³ Germany has also slipped in its support for UN development. As of 2008, Germany ranked 10th among voluntary contributor nations to the World Food Program and ranked 12th in giving to the UN Development Program.²⁴ Yet, not unlike British efficiency proficiency, German officials do not tolerate questionable aid delivery practices, suggesting that even their limited aid may be used more efficiently. As the third-largest donor to the Global Fund to Fight HIV/AIDS, Malaria, and Tuberculosis, Germany recently suspended its annual funds (more than €200 million) based on accusations of corruption.²⁵

17. Watkins, *Building on the Inheritance*.

18. OECD, "Development Aid Rose in 2009."

19. Alessandro Bozzini, *Development Aid in Europe: Set to Miss the 2010 Target*, ISPI Policy Brief, No. 201, November 2010, p. 3, http://www.ispionline.it/it/documents/PB_201_2010.pdf.

20. Richard Johnson, "Germany Receives Kudos Mixed with Criticism," IDN-InDepthNews, Global Cooperation Council, October 27, 2010, <http://www.indepthnews.net/news/news.php?key1=2010-10-27percent20:57:02&key2=1>.

21. CONCORD AidWatch Initiative, *Penalty Against Poverty: More and Better EU Aid Can Score Millennium Development Goals*, June 10, 2010, p. 27, <http://www.actionaid.org/assets/pdf/concordreportlight.pdf>.

22. Ibid.

23. ONE, *The Data Report 2010: Monitoring the G8 Promise to Africa*, <http://www.one.org/report/2010/en/about/summary/reportcard.html>.

24. Petra Bornhöft, "Masters of the Empty Promise: Germany Fails to Live up to Aid Pledges," *Der Spiegel*, March 17, 2010, <http://www.spiegel.de/international/germany/0,1518,683820,00.html>.

25. BBC News, "Germany Halts Aids Fund Payment over Corruption Claims," January 27, 2011, <http://www.bbc.co.uk/news/world-europe-12294232>.

Germany will come under increasing political pressure to meet its previous aid commitments. As part of the EU's collective 2010 ODA budget shortfall, Germany is responsible for €2.6 billion of the total €11 billion shortfall, and it has remained silent on any plan or vision for future development.²⁶ It will also hear strong criticism of its increasingly broad definition of aid, its general reluctance to provide humanitarian assistance to needy countries, and its preference to direct its aid to countries or markets that are attractive to German exports. In an age of austerity, it is unlikely that Germany will dramatically increase its ODA. To lessen international criticism and avoid isolation, however, Berlin will likely increase its overall ODA and justify that increase to its taxpayers by increasing tied aid to export growth countries. Whereas the UK has eliminated ODA to Russia and China, look for Germany to enhance its programmatic activities in that direction.²⁷

The Outliers: Poland and the Netherlands

Because Poland was the only European economy to witness positive growth in 2009, a closer examination of its ODA policies is warranted. Poland was one of 13 European countries to increase ODA in real terms in 2009, although Poland's increase was not the highest (oddly, Hungary's ODA increased by 23.1 percent in 2009 despite significant economic hardship).²⁸ In fact, Poland's ODA is one of the lowest in the EU, falling behind other Central European nations. In 2009, its ODA levels as a percentage of GNI were stagnant as compared to 2008 at 0.08 percent—one of the worst showings in Europe.²⁹

Despite its overall economic strength, Poland does not appear to be stepping into the role of international development leader. If anything, it is modeling the behavior of many European countries in the 1990s, namely in the form of implementing tied aid and diplomatically strategic spending. China receives a large portion of Poland's bilateral ODA, packaged in the form of tied loans to assist Polish firms increase their export market.³⁰ The other principal recipients are Afghanistan—accounting for 30 percent of Poland's bilateral ODA and managed by Poland's Provincial Reconstruction Team—and the Eastern Partnership countries (Poland's closest neighbors)—Belarus, Ukraine, Georgia, and Moldova.³¹

In contrast to Poland, the Netherlands is a major European donor. Recently, however, its ODA policy has suffered at the hands of both the economic crisis and the political influence of anti-immigrant and xenophobic political parties within a fragmented and weak coalition government. For the Netherlands, ODA in 2009 fell by 4.5 percent.³² However, with the release of the October 7, 2010, coalition agreement "Freedom and Responsibility," Dutch ODA will be reduced by €1 billion beginning in 2012 and existing ODA budgets will finance so-called global public goods and not traditional development.³³ Previous Dutch coalition agreements have consistently agreed to 0.8

26. CONCORD, *Penalty Against Poverty*, p. 2.

27. Department for International Development, "Spending Review 2010."

28. CONCORD, *Penalty Against Poverty*, p. 2.

29. *Ibid.*, pp. 8–9.

30. Leigh Phillips, "Dwindling EU Development Aid Spent on Deporting Refugees, Museum Gift Shops," *EU Observer*, October 6, 2010, <http://euobserver.com/9/30260/?rk=1>.

31. CONCORD, *Penalty Against Poverty*, p. 12.

32. OECD, "Development Aid Rose in 2009."

33. Bloomberg, "Wilders-backed Dutch Government Plans to Cut Immigration, Development Aid," October 14, 2010, <http://www.bloomberg.com/news/2010-10-14/wilders-backed-dutch-government-plans->

percent of GNP toward development and debt relief. With this new agreement, Dutch ODA will be reduced to 0.7 percent of GNP (which equates to a loss of €750 million) with an anticipated 15 percent reduction for the 2011–2012 timeframe. Furthermore, the leading official responsible for Dutch ODA has been downgraded from a development minister to a state secretary.³⁴

This recent coalition agreement in the Dutch parliament also calls for the Dutch government to argue that the OECD's DAC should change the ODA criteria to include peacekeeping operations in developing countries. For their mission in Afghanistan during 2002–2008 the Dutch government spent nearly €1 billion. Were that €1 billion to have been part of their ODA, it would have represented 10 percent of their annual bilateral aid.³⁵ In short, including security spending in ODA budget totals would mean an ultimate loss in traditional aid spending. Though this change to OECD ODA criteria is unlikely to happen, the fact that the Dutch debate has developed so far internally speaks to the level of current concern over international aid spending.

The new Dutch government provides a chilling template for future European coalition governments that must find a way to work with xenophobic parties. The Netherlands is also one of many growing European voices arguing for a broader definition of ODA, a sentiment largely stemming from experiences in Afghanistan. Look to this movement to become more boisterous as international criticism increases when European countries fail to meet their MDG targets in 2012.

Aid Inflation: Created or Exacerbated by the Crisis?

There will be vigorous debate about whether the European sovereign debt crisis caused a general deterioration in European development aid levels or simply exacerbated trends that were apparent before the crisis began. For the purposes of this analysis, there is an assumption that both elements are contributing factors. There is also contentious discussion about what constitutes “genuine aid” versus “aid inflation.” For the purposes of this discussion, aid inflation is generally defined as a country's ODA contribution plus its debt cancellation, refugee costs, student costs, and tied aid. According to CONCORD's 2010 EU Aidwatch Report, only 6 of the 27 EU member states will meet their ODA targets for 2010 *without* aid inflation because these countries so far surpass their percentage of ODA to GNI.

One estimate of aid inflation has EU member states attributing €1.4 billion of aid to debt cancellation, €1.5 billion to foreign student costs, and €1 billion to refugee-related expenses. When this aid inflation is removed from total aid spending, real spending on aid comes in €19 billion short of target levels.³⁶ Another disturbing European aid trend has been to move away from aid to least-developed countries (LDCs) and toward aid to pre-EU accession countries, EU Border States, resource-rich countries, and high-profile operations, such as Afghanistan.³⁷ Most troubling has been the robust embrace of tied aid or ODA that is funneled to domestic companies abroad. It

to-cut-immigration-development-aid.html; Dirk Willem te Velde, “Policy Coherence for Development or Development for Policy Coherence?” *The Broker*, October 7, 2010, <http://www.thebrokeronline.eu/Online-discussions/Towards-a-global-development-strategy/New-Dutch-government-reshaping-foreign-policies/Policy-coherence-for-development-or-development-for-policy-coherence>.

34. Te Velde, “Policy Coherence for Development.”

35. Ibid.

36. CONCORD, *Penalty Against Poverty*, p. 10.

37. Ibid., p. 17.

is estimated that almost 40 percent of all ODA is tied to donor goods and services with more than \$13 billion spent on donor consultants, greatly inflating the real value of aid.³⁸ Spain, Italy, Greece, and Austria tie more than 30 percent of their aid to their own goods and services, with Portugal tying more than 70 percent.

Beyond tied aid, one of the most popular trends is to increase lending to poor countries as grant aid is reduced. While the multilateral development banks have benefitted from the uptick in lending, least-developed countries will grow more deeply indebted. Multilaterally, the OECD reports that while the percentage of ODA provided to multilateral institutions has remained fairly stable, the share of these funds disbursed by the UN has decreased. Additionally, donor countries are earmarking their funds for specific purposes when channeling funds through multilateral institutions.³⁹ Moreover, calls for greater accountability will replace bold, new funding initiatives, and creative ODA accounting as well as new categorization will be expanded to the greatest extent possible.

Maximizing efficiency will become more than a platitude for European ODA for the next several years; it will become its mantra. As ODA budgets grow politically less palatable, European politicians and development officials will increasingly seek to link aid to good governance and to stop funding programs at the first sign of inefficiencies, such as corruption or administrative duplication. As EU Development Commissioner Andris Pielbags noted last year, “The real challenge is how Europeans will use the 0.7 percent so that it really has the impact our taxpayers expect. . . . Our taxpayers expect that there is a visible change in the conditions of life in developing countries.”⁴⁰ Unfortunately, efficiency and development are not always synonymous. Although European taxpayers may wish to see more efficiency for their euro, they remain positive about the importance of ODA, with 90 percent of Europeans supporting the importance of ODA and 72 percent in support of honoring or going

Africa Fact Box

- The Gleneagles Summit for Africa committed to increasing aid to Africa by \$25 billion—it is not expected to increase by half that much.¹
- Ireland reduced its ODA budget by 24 percent in 2009; approximately 80 percent of that budget is destined for sub-Saharan Africa.
- Italy decreased its ODA to sub-Saharan Africa by \$331 million in 2009.²

Notes

1. OECD, *Development Co-operation Report 2010*, April 23, 2010, p. 25, http://www.oecd.org/document/62/0,3746,en_2649_33721_42195902_1_1_1_1,00.html.
2. ONE, *The Data Report 2010*.

38. EURODAD (European Network on Debt and Development), “Aid Levels,” <http://www.eurodad.org/aid/?id=122>.

39. Bodo Ellmers, “More Development Aid Channeled through the Banks as UN Is Increasingly Sidelined, OECD Report Finds,” EURODAD, September 8, 2010, <http://www.eurodad.org/whatsnew/articles.aspx?id=4230&LangType=1036>.

40. Jefferson Chase, “Less Bureaucracy, More Efficiency as Europe Ponders Aid Future,” Deutsche Welle, December 7, 2010, <http://www.dw-world.de/dw/article/0,6302562,00.html>.

beyond existing aid commitments despite the economic crisis.⁴¹ American development experts are hopeful that the European drive for efficiency will not overshadow the need for greater effectiveness of the aid itself. In fact, the U.S. government has stated that with the EU it is “determined to forge a rational division of labor among donors to make each foreign assistance dollar go farther and focus on results rather than on inputs.”⁴²

41. European Commission, *Development Aid in Times of Economic Turmoil*, Special Eurobarometer, October 2009, p. 3, http://ec.europa.eu/public_opinion/archives/ebs/ebs_318_en.pdf.

42. Office of the Press Secretary, “Fact Sheet on the United States’ Relationship with the European Union: An Enduring Partnership,” White House, November 20, 2010.

3

OUTLOOK FOR DEFENSE

DOING LESS WITH LESS?

Stephen J. Flanagan, T. J. Cipoletti,
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Immediate Impact of the Financial Crisis

In the immediate speculation about European governmental austerity measures in late 2009, it was assumed that defense would be targeted for major cuts. If faced with a tradeoff between funding entitlements, such as pensions, health care, and social welfare payments versus defense, the choice would be obvious. In Europe, “abstract notions of national security and defence mean little when fundamental issues of social existence are at stake.”¹ This seemed particularly true, as NATO members know they can ultimately rely on the United States to provide for security. As one scholar commented about the “free rider” impulse, “if you knew you had the world’s most powerful military obligated by treaty to ride to your rescue, where would you make cuts?”²

In looking at the defense landscape in early 2010, these anticipated negative trends appeared to be on the horizon. Most European states had embarked on ambitious fiscal consolidations and defense was going to have to play its part. The cuts envisioned were assumed to substantially threaten the force structures of a whole array of European forces: Germany was considering cuts of €8.4 billion over the next four years (3.3 percent annually), Italy 10 percent of its budget, the Netherlands 20 percent,³ France a cut of €5 billion (5 percent) over the next three years,⁴ and the UK was envisioning a cut of between 10 and 20 percent.⁵

These plans have only partly come to fruition. Compared to other governmental spending, defense has generally been cut less deeply than other sectors. In Germany, defense will have to bear only 10 percent of the fiscal adjustment (€8.1 of €81 billion); in France defense will have to absorb only 6.6 percent (€3.5 of €45 billion) of the government austerity plan. Defense spending in Italy will actually increase despite a government-wide €25 billion spending reduction. The defense sector is taking only an 8.5 percent hit in an across-the-board 20–25 percent cut in Britain, and Spain will cut just €500 million in defense as part of a €20 billion austerity package. Even where defense has been hit more severely, as by the 20 percent cuts in Romania, this was usually in line with overall spending reductions. Compared to its share of overall national budgets, which averages between 4 and 5 percent, it seems as though defense has been assigned a fair, but still constraining, part of the austerity burden—for now.

1. Jack Treddenick, “The Dynamics of World Military Expenditures and the Ways of Providing National and Coalition Forces with AME under Conditions of the Global Financial Crisis” (remarks, roundtable discussion, “Ukraine’s Military-Industrial Complex during the Global Financial Crisis,” Kiev, October 14, 2010).

2. James Joyner, “NATO’s Identity Crisis,” *World Politics Review*, October 2010.

3. Michel Kerres, “Cutbacks Take Their Tolls on European Armies,” *NRC Handelsblad*, April 9, 2010.

4. Pierre Tran, “French MoD Won’t Deny Reports of Budget Cuts,” *Defense News*, May 27, 2010.

5. Andrew Chuter, “U.K. Defense Cuts To Be Deep, Painful, Experts Warn,” *Defense News*, September 6, 2010.

Given the overwhelming size of social welfare and education expenditures compared to defense, the emphasis on cutting the former doesn't come as a surprise. In the debates on what to cut, defense was supposed to "play its part" but was rarely identified as a primary target. Defense budgets and weapons acquisition decisions in Western Europe have been largely removed from the pressures of domestic politics. Rather than the result of guns-vs.-butter trade-offs, European force postures and spending patterns are instead reflective of threat perceptions and the role that the public and national elites want their nations to play on the world stage.

The following factors explain the relatively limited recent defense budget reductions:

- *Continued engagement in Afghanistan:* The Afghanistan engagement offered a persuasive explanation for protecting operational budgets. The shortcomings of European equipment are relatively well known to publics, so maintaining support for "troops in the field" has helped stave off near-term cuts.
- *Alliance responsibilities:* A common theme for safeguarding budgets is the requirement to live up to responsibilities under the EU's Common Security and Defence Policy (CSDP) and NATO.
- *Protecting ongoing reform efforts:* Many countries have recently undergone or are still in the process of major reforms, which mostly seek to reduce the number of forces and therefore limit the need/possibility to reduce even further.
- *Contractual impediments:* Most defense spending involves long-term commitments from governments that are difficult and often expensive to reverse. The second British aircraft carrier, which will be acquired just to be mothballed or sold, demonstrates that immediate cuts in major, long-standing procurement efforts are difficult to implement.⁶
- *Defense industry concerns:* As about 80 percent of European procurement is national, defense industry concerns further constrain budgetary flexibility in procurement.

While these facts continue to hold true in the short term, the mid- to long-term consequences of the economic crisis suggest tough times ahead:

- The relative protection of defense spending in 2010 could be misleading. If their economies continue to struggle, many countries will be forced to trim discretionary spending over the longer term in order to reduce their deficits. The end of the Afghanistan engagement after 2014 will remove one of the major reasons for public support for defense spending. At the same time, social tensions will likely rise as populations start to feel the cuts that have not yet been implemented in other government services. This combination is likely to lead to calls for a "peace dividend" and could, in combination with the potential for some political instability, bring about defense policy adjustments.
- Future limits on government spending—including those due to EU and IMF guidelines—in combination with looming age-related spending, will continue to exert medium- to long-term pressures on defense budgets. Even if budgets are held at constant/inflation-adjusted levels, the traditionally higher inflation rates in the defense sector as well as the growing pension burden inside the defense budget will covertly hollow out European defense budgets.

6. Derek Braddon, "What Lies Ahead? Defence, Budgets and the Financial Crisis," *NATO Review*, edition 4, 2009.

Impact on Future Capabilities

The financial crisis hit Europe at a time when all countries have undergone major reductions in their force structures since the end of the Cold War and most are still in a process of transformation. A change in threat perceptions from instability along Europe's periphery to diverse global challenges, in combination with constant technological innovation, had made the primary goal of these reforms to increase the proportion of capable and sustainable forces that can be deployed in international operations. At the same time, the fact that the new threat was also significantly lower led to a continuous reduction in funds over the last two decades.

In November 2010, the CSIS Defense-Industrial Initiatives Group (DIIG) published *European Defense Trends 2001–2009*. The report shows that Europe gets relatively less capability from its defense investments than the United States does. Protection of domestic industrial bases (including through the lack of standard acquisition regulations) and a fragmented market have led to duplication of effort and inefficiencies in spending. European governments remain saddled with many legacy programs and, even prior to the crisis, struggled to produce flexible forces capable of conducting and sustaining expeditionary operations. In an analysis of defense spending in 37 European countries, two apparently contrasting trends are evident:

- On the one hand, total defense spending in Europe has fallen from €251 billion to €218 billion between 2001 and 2009.
- On the other hand, per-soldier spending in Europe increased from slightly above €73 thousand to more than €91 thousand during the same period with a relative shift of spending toward equipment, operations, and maintenance and away from personnel and infrastructure.

This contrasting trend between total and per-soldier defense spending in Europe is primarily driven by shrinking European armed forces. Savings in personnel and infrastructure costs resulting from troop decreases further financed the costs of ongoing international missions and equipment based on emergency operational requirements. With cuts in troop numbers clearly outpacing cuts in budgets, European forces were able to spread constant or reduced resources across a declining number of soldiers, which in turn enabled an increase in the quality of military forces.

The opposing trends of overall European defense spending versus spending per soldier therefore suggest a *possible* movement within European armed forces toward replacing quantity with quality and an increasing willingness to invest in the immediate modernization of the capabilities of those armed forces. There is a tendency toward maintaining a few smaller, more agile units capable of undertaking expeditionary operations. This will affect how European states allocate their defense resources. About half the NATO allies currently spend more than 50 percent of their defense expenditures on personnel, and only eight spend more than 20 percent of their budgets on investment and modernization.⁷ The trend to acquire fewer units of more-advanced and more-expensive equipment will also have implications for defense industry.

The CSIS DIIG report provides two key insights into the future of European forces. On the one hand, higher per-soldier spending *could* enable European states to create smaller yet better-trained and better-equipped forces by concentrating available resources on those units. While initial

7. Adrian Kendry, "Allied Defence Budgets in Light of the Global Economic Crisis" (presentation to the NATO Parliamentary Assembly Annual Session, Economic and Security Committee, Edinburgh, November 15, 2009).

upfront costs are likely, long-term savings could be shifted to investment and training accounts. On the other hand, should maintaining stable defense spending prove elusive in the future, further troop reductions would be required to maintain the momentum toward more capable forces. It will be more difficult if typical European inefficiencies are not addressed. It remains anything but certain that European governments will respond by spending their diminished defense resources more wisely, and they may have to reduce both force structures and capabilities.

Operations and Resources

While the costs of current operations have grown significantly for most European countries, they have been largely insulated from cuts. Afghanistan is the primary focus of national military efforts with some countries significantly reducing other commitments or programs in order to maintain or even increase their levels in the International Security Assistance Force (ISAF). For example, the UK Strategic Defence and Security Review cited the overriding priority of providing combat air support in Afghanistan during the next five years with a (reduced) fleet of Tornado aircraft as one of the reasons to retire its carrier-based Harrier strike aircraft. Debate in Europe over the ISAF mission has focused more on goals and feasibility and on human rather than financial costs—although that may be changing.

The impact of operations on general military and security capabilities is mixed. Operational funding generally does not exert exceptional pressure on the defense budgets of larger European nations, where it typically constitutes a small fraction of overall defense allocations. Several countries rely on additional funding from the general budget, as in the UK, where, similar to supplemental appropriations in the United States, ISAF mission funding of about £4 billion is provided from the Treasury's Special Reserve. However, for nations with relatively modest defense budgets and very ambitious engagements, such as Poland and Romania, these expenditures constitute a significant part of their defense budgets, for which they are only partially compensated by U.S. and coalition assistance.

The different sources of mission funding determine the impact of budgetary adjustment on overall force structure and modernization. It is clear that, if current operations are to be ring-fenced and prioritized over other issues, a crunch in the defense budget will exert great pressure on the remaining expenditure accounts. While this would appear to be a clearly negative side effect at first glance, such a prioritization can also serve as a potent transformational driver for conventional forces, as focusing scarce resources on mission-related equipment and capability development would help to overcome structural inertia and service traditionalism.

In terms of training and force readiness, two contrasting trends have to be considered: deployment-related training and operational experience itself have, especially where they were provided from outside the defense budget, led to a substantial increase in military capabilities. Some elements of European forces, particularly infantry units, have reached unprecedented levels of training, particularly when it comes to high-intensity counterinsurgency (COIN) operations. At the same time, domestic and non-deployment-oriented force components struggle to maintain operational readiness after two decades of declining funds in the operations and maintenance accounts and, particularly, training. The economic crisis is likely to exert further pressure on those accounts, which represent the most discretionary part of defense budgets. This situation is going to persist. In cases such as Italy and Bulgaria, in-theater and pre-deployment training through

Operations: Double-edged Impact on Modernization

President Bronisław Komorowski has lamented the negative side effects of current operations on the modernization of the Polish Armed Forces.¹ As 10 percent of Warsaw's defense budget is spent on financing its 2,600 troops in Afghanistan, procurement has recently focused almost exclusively on re-equipping its forces in ISAF. The government has had to initiate a significant number of urgent procurements for unmanned aerial vehicles (UAVs) and other force protection requirements, which helped to increase the investment share of the budget from 13.2 percent in 2001 to 24.4 percent in 2010. Yet, the focus on the mission coupled with reduced funding due to the economic crisis led to the postponement of programs for Poland's air force and navy, which disrupted their "2007–2012 Armed Forces Modernization Plan."² This clearly demonstrates the paradox such prioritizations often encounter. While international operations serve as key drivers of modernization and interoperability and help units to become, as the late Polish chief of defense General Franciszek Gągor put it, "real armed forces,"³ long-term, full spectrum modernization efforts and general restructuring of the armed forces are likely to suffer from the continued engagement in counterinsurgency and stabilization missions.

Where operations are funded from the general budget, their costs and related recapitalization and modernization have sometimes had less impact on other defense functions. To the contrary, "additional funding" has sometimes freed the procurement account from items such as infantry fighting vehicles, UAVs, or Future Soldier systems, which were to be acquired anyway. For example, the UK's Urgent Operational Requirements (UOR), which included more than 600 new Mastiff, Ridgeback, and Vector Protected Patrol Vehicles, as well as 200 Jackals, was funded entirely from the Treasury's Special Reserve and obviated the requirement for the Future Rapid Effects System (FRES) utility variant, which had been a contentious budget issue for years.⁴ Although there are limits to the amount of material that will be reusable, countries could possibly gain a net positive material effect through operations.

Notes

1. Slobodan Lekic, "Polish Leader: War Costs Slow Army's Modernization," Associated Press, September 1, 2010, http://www.boston.com/news/world/europe/articles/2010/09/01/polish_leader_war_costs_slow_armys_modernization/.
2. Bastian Giegerich and Alexander Nicoll, eds., *European Military Capabilities: Building Armed Forces for Modern Operations* (London: International Institute for Strategic Studies, 2008), p. 57.
3. "Interview: Gen. Franciszek Gągor, Poland's Chief of General Staff," *Jane's Defence Weekly*, November 14, 2007.
4. Terry Terriff, Frans Osinga, and Theo Farrell, *A Transformation Gap? American Innovations and European Military Change* (Palo Alto: Stanford University Press, 2010), p. 54.

operational funding has at times been the only means by which training was still provided.⁸ With the end of the Afghanistan engagement, operational readiness of ground forces may gradually decline to pre-Afghanistan and pre-Iraq levels as more and more veterans leave the force and new service members are not trained adequately. In the air domain, a number of countries are likely to further reduce training hours for pilots of combat aircraft well below the previous NATO average of 140–180 hours a year. This will have serious consequences for the operational readiness of forces and interoperability among allies.

In the absence of a renewed commitment to Afghanistan or a new mission elsewhere, the resource requirement for operations in Europe will decrease until 2015. The impact of such decreases on force structures will depend on the means by which funding was previously provided. While forces with intrabudget funding may be relieved, forces that could previously draw on operational funding will be subject to further pressures. At the same time, forces will face a serious risk if calls for a peace dividend after the withdrawal from Afghanistan materialize. Such a development could offset any eventual benefits.

The crisis is likely to diminish the willingness of European governments to undertake a range of future missions. Strategic reviews such as the UK's National Security Strategy have already included notions that future interventions should be considered more carefully and undertaken only as a last resort when fundamental interests are at stake. The recent wave of white papers and the NATO Strategic Concept have reflected an increasing focus on enhanced crisis management efforts to prevent conflict. If taken seriously, however, "prevention" would actually require increased engagement abroad. As budget plans do not account for such prospects, it has to be assumed that much of the recent "prevention" discourse is driven by recognition of growing limitations in operational capacity and an inclination to limit the scope of future missions.

The availability of extrabudgetary funding in the future is highly questionable. The UK's special-reserve funding for Afghanistan barely survived the SDSR and likely will not be available for potential operations. In Germany, plans to fund missions entirely from the federal budget have not materialized. All over Europe, treasuries are exerting growing pressures to reign in mission funding, which year after year has vastly exceeded expectations. Tradeoffs are becoming more common. The Netherlands was forced to sell equipment to finance its missions, while the Czech Republic and Italy had to reduce other engagements to be able to maintain their Afghanistan contingents, and even in the UK the procurement part of annual 2008 Special Reserve funding was limited to £600 million.

The crisis might also lead to a rethinking of NATO's decade-long focus on developing expeditionary capabilities. The probability that European members of NATO would willingly undertake another mission on the scope of Afghanistan is minimal. Given the increasing political and economic costs of overseas engagements, there is a significant risk of an isolationist mentality taking shape in Europe that may result in governments concentrating on countering threats at home and shying away from military missions abroad. To the extent they are willing to undertake expeditionary crisis-response operations outside the North Atlantic area, European governments will want "fast-in and fast-out" operations with explicit exit strategies, which could be very problematic—as evidenced by the difficulty of defining the endgame of NATO's Operation Unified Protector to safeguard Libyan civilians in early 2011. After all, none of the operations in which NATO is currently engaged was planned to be sustained over the long term.

8. Jane's Military Assessments, "Italy" and "Bulgaria," Jane's Military and Security Assessments Intelligence Centre, 2010.

Equipment Recapitalization and Force Fatigue

For all countries, the question remains how much of the equipment engaged in current operations will be reusable. Current European defense spending plans foresee a shift toward maritime and air capabilities as well as new defense functions after 2012. There is significant risk that many mission-related expenditure items—particularly for land forces—will fall victim to impairment, leaving expeditionary forces with a need for recapitalization at a time when funding will be focused elsewhere. The recent experience in Iraq demonstrates that significant proportions of material may no longer be useable after the Afghanistan engagement. For example, when the British left Basra in 2008, their operational costs actually increased by £0.5 billion, largely as a result of writing off equipment.⁹

Apart from the material side, many European units are also suffering from a high degree of fatigue. The limited availability of well-trained and deployable troops in Europe has led to an uneven burden on the most operational parts of the forces, many of whom have significantly exceeded the foreseen deployment rotations. This has been accompanied by a growing discontent and a bifurcation of the forces into parts that have been working at a high operational tempo over protracted time periods, while others have hardly deployed at all or have hardly left base structures—a fact that is most harshly reflected in casualty rates.¹⁰

Capability Investments

Even before the onset of the financial crisis, most forces were scheduled to become considerably smaller. The CSIS DIIG study showed that if troop cuts were to continue to outpace budget cuts, this could increase spending per soldier, a proxy variable for a higher quality of forces. However, this recognition came with several caveats. Rather than reflecting a deliberate decision of the political elite, the increase in per-soldier spending could represent nothing more than a time lag in the responsiveness of procurement and investment spending, which will realign with per-soldier spending at the same level in the medium term to long term.

Economically, and therefore of more relevance to the crisis, if defense spending cannot be sustained at constant levels, perpetuation of the trend toward higher per-soldier spending might require a further reduction in force levels. At the same time, higher inflation rates in the defense sector than in other economic areas as well as the growing pension burden will put internal pressures on defense budgets, so that constant spending could still mean a significant real reduction in available resources. Achieving a “leaner, but meaner” force will therefore be a formidable challenge.

The belief that troop reductions will save costs and improve capabilities by increasing the percentage of enlisted versus commissioned personnel and rejuvenating the force is not a given. Most Europeans already suffer from a top-heavy overhang of officers and noncommissioned officers, who due to their limited employment prospects will only very unwillingly leave their forces.

9. Richard Norton, “UK Military Costs in Afghanistan and Iraq Soar to £4.5bn,” *Guardian*, February 12, 2009, <http://www.guardian.co.uk/uk/2009/feb/12/british-costs-soar-in-afghanistan-and-iraq>.

10. For example, in Germany infantry from the same four battalions have been deployed again and again, forming the 750-men-strong “fighting” component of a deployment of 5,350 soldiers in a 230,000-soldier force.

Contractual constraints, outdated force catalogues, and a lack of funding for incentives as well as the risk of primarily young and flexible troops opting out will make force restructuring and reduction a difficult—and eventually expensive—process. Recent experience in many allied countries evidences the perils of force reduction. In Canada, incentives for those who opt out have led to a dramatic drawdown in younger generations. In Romania, the forces' entire age structure was turned upside down. The cases of Spain, Sweden, and Italy show that the shift toward smaller and more professional armies may also require considerable up-front costs, particularly for personnel and training. In Italy, where conscription ended in 2005, costs are still rising, while the proportion of officers to noncommissioned personnel has reached 1:1.19.¹¹ Recruitment in Spain has proven so difficult that the military has been opened to foreign nationals, which now make up 7 percent of the forces. The United Kingdom fields a considerable component of Commonwealth soldiers, particularly from Fiji, and because of mounting recruitment problems the hiring of foreign nationals has even been discussed in Germany. Demographic change will only worsen this situation, as an increased focus on enhancing service attractiveness will drive up costs.

These facts should serve as a warning sign for those who consider force reductions a simple and direct method for cutting costs. While long-term savings might follow, it will cost money to save. Curtailing recruitment, higher standards for promotion, options for early retirements, well-targeted incentives, and a flexible career system will be crucial in creating a balanced force.¹²

Even if the reduction in troop numbers diminishes overall personnel spending in the medium to longer term, addressing new challenges such as cyber, ballistic missile defense, and space will require allocation of additional defense resources. With operations having driven the shift toward more expeditionary forces, the transformational dimensions of network-centric warfare (or, as preferred in Europe, “net-enabled capability”) and an effects-based approach to operations will drive developments over the next decade. Considerable funds for all these initiatives will likely have to be found in the budget and will gradually consume a greater proportion of dwindling resources.

Despite these worrisome trends, some of the most urgent European deficiencies including force protection, deployability, and information superiority are actually set to improve in the coming years.¹³ Plans for addressing these shortfalls in the 2011–2015 timeframe will not be severely affected by crisis measures. The NATO Strategic Airlift Capability (SAC) has already proved to be a great enhancement for Eastern allies and partners. Due largely to contractual obligations, key programs like the NH-90 as well as the A400M will still be acquired—albeit in lesser numbers—

11. Luca Peruzzi, “Italy Special: Italian Defence Programmes Hit by Budget Squeeze,” *Flightglobal.com*, November 16, 2010.

12. “Reform der Bundeswehr,” *SWP-Aktuell*, German Institute for International and Security Affairs, November 2010.

13. The European Union identified the following critical shortfalls: “Information Management - Fuel & Power - Deployable Air Power for ESDP Operations - Rapid Land Manoeuvre in the 21st Century - Sea-basing - Open Source Intelligence (OSINT) - Space - ISR Sensors and Collectors - Electromagnetic Spectrum Management - Wide-area Maritime Surveillance - Reception Staging and Onward Movement - Non-lethal Capabilities. Within the Critical Group, capability shortfalls related to Computer Network Operations, establishing and operating from austere bases and locations, Inter Theatre Transport, Vertical Lift, Air to Air Refuelling, and ISTAR Collection are of the highest importance. Additionally, capability shortfalls related to Airborne EW Protection, Mine/Ballistic Protection, Medical Force Protection, HUMINT, Airborne Command and Control as well as Power Projection were identified as Critical, although of lower importance.” See <http://register.consilium.europa.eu/pdf/en/09/st08/st08715.en09.pdf>.

Uncertain Funding for Missile Defense

There is considerable uncertainty about the ultimate costs, and what part of those costs, European governments are prepared to provide for the development of a comprehensive NATO missile defense system. At Lisbon, NATO leaders endorsed territorial missile defense as a core Alliance mission. The allies called for development of this system through expansion of the existing NATO Active Layered Theater Ballistic Missile Defense (ALTBMD) system and its integration with the U.S. Phased Adaptive Approach (PAA), based on the U.S. Navy's Aegis Ballistic Missile Defense System. Secretary General Rasmussen estimated that development of the system would cost about €200 million (\$260 million) over 10 years, to be supported by common NATO funding. This figure would be in addition to the cost of upgrading the ALTBM program, which is expected to cost €800 million over 14 years. However, a NATO-mandated industry study in December 2010 concluded the costs could be much higher.¹ The cost of deploying the Aegis missile cruisers, sea- and land-based missiles, and other C3 and sensor components will be much more and be borne by individual nations. It is not clear how the PAA components will be funded or what future capabilities European governments will be willing to procure. Norway and Spain have Aegis-equipped ships, and the UK and German navies have ships with the ability to conduct long-range radar surveillance and missile target tracking.

One indicator of the challenges missile defense will encounter is the fate of the trilateral Medium Extended Air Defense System (MEADS), which was designed to replace the Patriot missile in the United States and Germany and the Nike Hercules in Italy. MEADS experienced considerable cost increases and delays that raised concerns on both sides of the Atlantic. In February 2011, the Pentagon decided to continue support for design and development of the system through 2013 under the current memorandum of understanding, but not to purchase and field it. The Pentagon concluded that given delays in the availability of MEADS, it would be required to upgrade Patriot to ensure coverage but could not afford to procure both programs. Shortly afterward the German government followed the American decision by announcing that it would only complete the development phase to 2013 under current budget limits, while Italy is still exploring its options.² France, the UK, and Italy are working on a system comparable to Patriot.

Notes

1. Steven A. Hildreth and Carl Ek, *Missile Defense and NATO's Lisbon Summit*, Congressional Research Service, December 28, 2010, <http://www.fas.org/sgp/crs/row/R41549.pdf>.
2. Tom Kington and Albrecht Müller, "2 of 3 MEADS Partners Cancel Production," *Defense News*, February 21, 2011, <http://www.defensenews.com/story.php?i=5760950>.

and urgent operational requirements have improved force protection issues in many European forces with further progress likely until 2015.

As outlined, investment decisions driven by the protection of the domestic defense industry could have further devastating effects on the operations and maintenance accounts. Such a development would lead to the paradox of the availability of modern equipment but a lack of skill to operate it due to crumbling training efforts. In many countries, readiness outside the deployed forces has already plunged. As outlined by the Italian defense journal *Analisi Difesa*, “it has been years since complex exercises at brigade level have been carried out. ... Only units due to go to deploy receive adequate training, while the rest is gradually losing efficiency and probably morale.” The Italian budget proposal itself states that “the operational organization cannot absorb further spending reductions without falling short of meeting the fundamental standards required at international levels.”¹⁴ Similarly, the low level of readiness of nonmission forces in Bulgaria is concerning.¹⁵ Building a “meaner, but leaner” force requires not only steady procurement, but also a force that is appropriately trained and whose equipment is provided with adequate maintenance. As deployments are likely to be in a multinational context, interoperability through appropriate participation in multinational exercises will be critical, particularly once in-theatre cooperation ends.

At Lisbon, the Alliance set relatively modest but still costly force improvement goals. Considering the fate of the Defense Capabilities Initiative of 1999 and the Prague Capabilities Commitment of 2002, as well as several EU initiatives, the upcoming implementation phase will serve as a key litmus test. The Lisbon Capabilities Package includes initiatives to develop counter-IED capabilities, collective medical support logistics and other operational requirements, missile defenses, and cyber. It also calls for pursuit of key enabling capabilities including information systems for more effective decisionmaking and C2 (command and control) and improved arrangements for sharing intelligence. But fiscal constraints seem likely to impede realization of commitments made at Lisbon.

The U.S. Congress will look at the transatlantic balance of effort at a time when Europe is slashing its defense. In overall defense spending, the relative disparity between U.S. defense expenditures (approximately 4.5 percent of GDP) and the average expenditure of the 27 other Allied nations (around 1.5 percent of GDP) is likely to grow. Recent calls on Capitol Hill for reducing the U.S. military presence in Europe, based on a perception of European free-riding on security, could be a first indication of a new transatlantic burden-sharing debate.¹⁶

Preserving Key Capabilities and Infrastructure

Current defense reforms more often than not include the complete abandonment of some capabilities. Maritime surveillance, mine-hunting capabilities, anti-submarine warfare, and others are among the first areas that have been given up. While, as in the case of British carrier strike, this is sometimes a temporary abandonment aimed at reacquiring the capability in the short to medium term, it often results in a permanent abandonment—especially in smaller countries. If it is

14. Italian Ministry of Defense, “Nota aggiuntiva allo stato di previsione della difesa per l’ anno 2010,” March 2010, http://www.difesa.it/NR/rdonlyres/E006A984-0E90-42F4-A2CA-BDCAACADDFCE/0/Nota_Aggiuntiva_2010_definitiva_Gaeta_09_04_2010.pdf.

15. “Armed Forces: Bulgaria,” Jane’s Military and Security Assessments Intelligence Centre.

16. Leo Michel, “Now Comes the Hard Part,” *Atlantisch Perspectief* 34, no. 8 (November 2010): 14–18, http://www.atlcom.nl/upload/AP%202010%20nr_%208.pdf.

an attempt at limited role specialization, this does not seem particularly worrisome. For example, the phasing out of Danish submarine capabilities will not do significant harm to Alliance security. While they have leased 14 Gripens, the Czechs and other smaller NATO allies are debating whether they need to maintain air superiority fighters and can rely on NATO commitments. A scenario often cited by UK analysts is that the lack of an operational aircraft carrier over the next decade could limit British capacity to defend the Falkland Islands and other South Atlantic Overseas Territories. However, the SDSR contends that access to overseas bases could compensate for this shortcoming until the new *Queen Elizabeth* carrier becomes operational between 2016 and 2020.¹⁷

The tendency of NATO member states to pursue their defense reforms in a purely national manner—with little awareness of others' efforts—could result in an across-the-board abandonment of key capabilities. The effect of operations in Afghanistan, and the assessment in NATO's new Strategic Concept (and other national defense reviews) that Afghanistan is representative of the kinds of irregular, hybrid conflicts in which allied armed forces can expect to engage in the future, will further steer all governments to search for savings in seemingly less relevant capabilities like "amphibious strike." Given that uncertainty is the most prominent characteristic of the modern security environment, such an abandonment can make Europeans vulnerable to surprise. Many European allies that assign a high value to territorial defense are, at the same time, relying on NATO to provide for such defense as they reduce their conventional capabilities. While they often emphasize retaining some capacity to regenerate their forces if a threat were to develop, such regeneration is neither quick nor easy. Certain European countries, including Denmark and the Netherlands, have consciously decided to specialize in capabilities for expeditionary missions and recounted themselves well in recent operations in Afghanistan. If a greater-than-expected threat to territorial security should arise, those forces could not contribute much to territorial defense. If capability gaps are to be avoided, role specialization will need to be carefully coordinated. While the Czech Republic's decision to concentrate on countering chemical, biological, radiological, and nuclear (CBRN) threats as well as providing national centers of excellence to NATO have been a first step in the right direction, the usual approach is still too supply, rather than demand, oriented.

As a result, there is a growing recognition that it may be necessary to invest in regenerative capabilities. The British Chief of Defence, General Sir David Richards, recently used the example of the German Reichswehr in the 1920s, which focused heavily on maintaining capabilities that could otherwise be reacquired only with great difficulty. One possibility to retain these capabilities would be to move much of the related equipment into reserve status and to maintain and train an appropriate number of reservists. The problem with legacy force material, however, is that moving it into reserve status can be costly, as the UK has begun to realize. Maintenance accounts are expected to be strained after the return of material from Afghanistan, especially where extrabudgetary funding was previously available. The costs of maintaining residual legacy equipment could further constrain scarce funds for acquiring and maintaining modern systems. Many conventional capabilities, especially for high-intensity operations, will also be hard to replace with reservists. Although they can bring high added value, reservists "aren't appropriate for everything because some of what we're doing today is extremely demanding in terms of training."¹⁸

17. John F. Burns, "Officers Tie British Cuts and Risk to Falkland Islands," *New York Times*, November 10, 2010, <http://www.nytimes.com/2010/11/11/world/europe/11britain.html>.

18. Sir David Richards, "Britain's Security Challenges in the Age of Austerity" (speech, Atlantic Council, January 6, 2011), <http://www.acus.org/event/britains-security-challenges-age-austerity/transcript>.

A particular value of reserves is to be found in their civilian expertise through which reserve personnel can substitute for shortfalls in nonmilitary capabilities. But the European system of reserves is too often still geared toward conscription service. Many forces face great changes in their reserve structure. While they could previously rely on masses of former conscripts, the potential cadre of reserve forces will be significantly lowered by the professionalization of forces. New models for an attractive reserve service have to be built to guarantee the stream of critical expertise.

Bottom Line: Smaller, Less Capable Forces Likely

Absent some politically difficult and costly course corrections, the tight fiscal circumstances over the next five years will further erode overall European military capabilities already suffering from two decades of underinvestment. As one longtime analyst commented, “Europeans simply can’t operate, maintain, and transform their forces while spending well under 2 percent of GDP on defense.”¹⁹ Although recent operations, particularly in Afghanistan, have advanced the transformation of European forces and made them more expeditionary, the readiness, equipment, and training of forces not involved in those operations is likely to continue to erode. Moreover, the political will to undertake demanding expeditionary operations is being undermined by economic constraints and operational fatigue.

The actions taken by the three most capable European NATO allies—the UK, France, and Germany—will be determinate. These three represent 65 percent of all defense expenditure in NATO Europe and 88 percent of all research and technology investment.²⁰ The UK-France Defence Co-operation Treaty and other elements of their proposed bilateral collaboration have the potential to produce new synergies and safeguard certain critical capabilities. But the mid-decade budget projections are not encouraging.

- The UK SDSR called for 8 percent cuts in defense spending over the next four years and then levels off. This will result in about an 18 percent cut in program resources, given a number of unfunded obligations. The British Army will be lighter and will lose a brigade headquarters and four infantry battalions. However, the land forces will still maintain two deployable division headquarters, five multi-role, all-arms maneuver brigades, an air assault brigade (with both airborne and heliborne infantry), and a single Royal Marine Commando brigade providing British decisionmakers and military leaders with a suite of land-based capabilities that are broadly employable and tailored to a variety of contingencies from humanitarian assistance to coalition war fighting. The Royal Air Force (RAF) and Royal Navy (RN) will be more profoundly affected by the reductions. The RAF will rapidly lose older aircraft (e.g., Tornados) and will acquire fewer new airframes (e.g., Typhoons and Joint Combat Aircraft) in return. The Nimrod MRA4 maritime anti-submarine warfare program has been cancelled. The navy will continue with plans to acquire two new aircraft carriers, but in exchange the current flagship carrier, the *Arc Royal*, along with all short-take-off Harrier aircraft, are being decommissioned in 2011; and the purchase of their planned replacement, the Joint Combat Aircraft, will be cut from 138 of the short-take-off and vertical landing F-35B variant to 40 of the more capable

19. Interview with senior NATO official, October 6, 2010.

20. Julian Lindley-French, presentation at “NATO Beyond the Lisbon Summit,” conference, CSIS, Washington, D.C., November 29, 2010; and Julian Lindley-French, *Britain and France: A Dialogue of Decline? Anglo-French Defence Cooperation and Implications for the European and Euro-Atlantic Security and Defence Relationships* (London: Chatham House, September 2010), pp. 31ff.

F-35C aircraft. Other major surface combatants will decline from 24 to 15–16, and further cuts in RN capabilities for maritime patrol are likely after 2014. The UK will be less able to undertake unilateral joint military operations (e.g., Iraq and Afghanistan) although it retains enough conventional military capability to be the lead coalition nation in a small-scale foreign contingency or make significant contributions to a much larger U.S.- and/or NATO-led mission. The UK is committed to maintaining a self-supporting brigade-sized force (6,500) capable of being deployed anywhere in the world and sustained indefinitely.

- The 2008 French White Paper on defense had already called for sharp reductions in the number of forces from 270,000 to 225,000. The army budget was to be cut by some 17 percent, the air force by 24 percent, and the navy by 11 percent over the subsequent six or seven years.²¹ The 2011 budget plan calls for a further 3 percent reduction in defense spending through 2013. Despite delays in some programs like the Mirage 2000D midlife upgrade, the purchase of multi-role tanker and transport (MRTT) aircraft, and parts of the Scorpion army modernization program,²² additional revenues and efficiencies will limit the impact of cuts in the near term. However, these are not sustainable in the out-years as the burden of increasing military pension expenditures and inflation threaten to slowly hollow out residual French forces. France has a long tradition of revising its military program laws, stretching out procurement plans over additional years. One analyst predicted that given the current resource projections, France will move from the past record of “losing 1 year of procurement for every 10 to losing one year out of five, which is a disaster.”²³ It seems likely that over the next five years, France’s army will shrink by one brigade, training for all services will be reduced, and some space capabilities will be postponed. Paris is committed to being in a position to simultaneously field 30,000 soldiers deployable within six months for a period of one year for a major operation, maintain 5,000 reservists on permanent operational alert, and have available up to 10,000 troops for territorial defense “in case of a national emergency.”²⁴
- In the face of budgetary pressures, the German government has undertaken a sweeping reform and downsizing of its armed forces. Former defense minister Karl-Theodor zu Guttenberg broadly endorsed the recommendations of the independent Weise Commission on the Structure of the Bundeswehr, including abolishing conscription and reducing troop levels by one-third from 250,000 to 180,000, which would require additional expenditures in the short term but produce savings in the medium to long term. Guttenberg was convinced that even deeper cuts in force levels to 163,500 were necessary to maintain a smaller but better-equipped Bundeswehr. Guttenberg’s popularity enabled him to push through the abolition of conscription, but political pressures have limited force reductions to 180,000 troops. Although this reform effort once appeared to be on track to provide a promising example for other European countries with similar force structures, the inherent difficulties of pursuing a comprehensive

21. Jonathan Marcus, “Trimmed French Military Is No Retreat,” BBC News, June 17, 2008, <http://news.bbc.co.uk/2/hi/7459214.stm>.

22. Pierre Tran, “France to Cut Spending \$4.8B over 3 Years,” *Defense News*, September 28, 2010, <http://www.defensenews.com/story.php?i=4799913>.

23. Comments at a CSIS workshop to review an earlier draft of this manuscript, Washington, D.C., February 18, 2011.

24. See “The French White Paper on Defence and National Security,” Présidence de la République, June 2008, http://www.ambafrance-dk.org/docs/dp_livre_blanc_ang.pdf.

force overhaul in times of financial distress are becoming more and more apparent. After Guttenberg's resignation in the face of a political scandal, the reform effort may be at risk. Despite the sizeable force reductions envisioned, the Weise Commission acknowledged that the percentage of overall German forces that are deployable and sustainable is quite low compared to other NATO countries. It advised more than doubling (from 7,000 to 15,000) the number of rapidly deployable, high-quality forces available for expeditionary missions.²⁵ But the rapid abolition of conscription has already led to fears about sizeable recruitment difficulties, as the number of applicants for the new volunteer service has fallen significantly short of expected numbers. In a February 2011 letter to the inspector general of the Bundeswehr, the inspector of the army warned of a growing gap between capabilities and operational requirements, noting that "in the transition to the new structure we will have to accept big holes in our personnel ranks that will accompany us for a long time and cannot be substituted," to the point that "the sustainment of mission contingents at the current level will not be possible already in 2012."²⁶ The German navy is facing the prospect of sizable personnel cuts (from 17,000 to as few as 11,000) and the loss of some equipment. While the navy will retain key strategic capabilities, cuts will curtail operational flexibility and ability to undertake large operations and lengthy training missions.²⁷ While the shift to an all-volunteer force could enhance overall readiness and effectiveness of the Bundeswehr, acquisition cuts, including anticipated reductions in the number of NH-90 transport and Tiger attack helicopters, Eurofighters, and frigates, coupled with the recently announced cutback in the number of A400M transport planes, will further constrain capabilities for high-end operations.²⁸

Given these trends among the big three and limited spending by other allies, NATO Europe will make only marginal improvements in capabilities to undertake various missions absent significant restructuring and defense integration. Most other allies will probably be able to contribute no more than a battalion to future expeditionary operations, but several will have enhanced special operations units and certain niche capabilities. In the naval domain, allies will be able to contribute limited numbers of surface combatants for crisis management, sea control, maritime security, and humanitarian operations, but reduced force levels will limit global presence and partner training missions, operational flexibility, and capacity to deploy, sustain, and support expeditionary forces—as called for in NATO's new maritime strategy. Only the UK and France will retain significant capability to support littoral combat or sustained operations. As became evident during the initial weeks of the Libya crisis in 2011, European air force capabilities will be constrained by shrinking fleets, reduced pilot training, and tight budgets that hinder sustained combat operations.

25. See German Ministry of Defense, *Bericht Die Strukturkommission der Bundeswehr*, October 26, 2010, <http://www.bmvg.de/fileserving/PortalFiles/C1256EF40036B05B/W28AL8JU967INFODE/Bericht%20der%20Strukturkommission%20der%20Bundeswehr.pdf>; and "Military Commission Recommends Cuts at German Defense Ministry," *Deutsche Welle*, October 27, 2010, <http://www.dw-world.de/dw/article/0,,6151848,00.html>.

26. "Bundeswehr fehlen Rekruten," *Der Spiegel*, February 17, 2011, <http://www.spiegel.de/spiegel/vorab/0,1518,746549,00.html>.

27. Stefan Nicola, "German Navy Faces Painful Cuts," United Press International, September 29, 2010, http://www.upi.com/Business_News/Security-Industry/2010/09/29/German-navy-faces-painful-cuts/UPI-83731285782376/.

28. United Press International, "Germany to Sell A400M Planes to Cut Costs," January 27, 2011, http://www.upi.com/Business_News/Security-Industry/2011/01/27/Germany-to-sell-A400M-planes-to-cut-costs/UPI-99451296151413/.

4

A HEALTHY, DIVERSIFIED DEFENSE INDUSTRY DESPITE DECLINING EUROPEAN DEMAND

David Berteau, Guy Ben-Ari, Joachim Hofbauer, and Roy Levy

European defense and security companies are distinctive from their corporate peers. Like commercial companies, they must generate competitive returns for their owners and lenders while simultaneously investing in next-generation capabilities. However, they must earn these returns while meeting stricter regulatory and political requirements than most commercial companies, including for profitability.

In the past decade, European defense and security companies have done well. Compared to their commercial peers, they have delivered matching or superior results for profitability and return on investment. This was a result of three main elements. First, European defense ministries have been very protective of their investment accounts. While total defense spending in Europe decreased between 2001 and 2009 by 1.8 percent annually, spending on defense equipment decreased by only 0.9 percent annually.¹ Second, European spending on homeland/societal security increased, and many companies positioned themselves for this. Third, European defense companies achieved greater exposure to foreign markets, including, but not limited to, the U.S. market. However, the economic and fiscal austerity experienced since 2009 on both sides of the Atlantic could reverse this trend.

This chapter will analyze the financial health of the European defense and security industrial base. Such analysis is an important element in assessing whether industry can remain viable and have the capacity and incentives to continue to provide European militaries with state-of-the-art and operationally relevant products and services in the unfavorable fiscal climate.

The CSIS ESDS Index

To assess the financial health of the European defense and security sector, CSIS created the European Security, Defense, and Space (ESDS) Index. The Index is made up of 22 publicly traded companies across Europe for which defense and security represent a significant revenue stream. In 2009, revenue for these companies ranged from €5 million to €23 billion. Companies in the Index represent both the hardware and services sectors and include both established and emerging defense capabilities. Many also operate nondefense businesses. Note that given the large number of privately held or government-owned European defense and security companies, the CSIS ESDS Index does not represent the entire European defense and security industry. The CSIS ESDS Index

1. See, for example, Guy Ben-Ari, David J. Berteau, Joachim Hofbauer, Gregory Sanders, and Roy Levy, *European Defense Trends: Budgets, Regulatory Frameworks, and the Industrial Base* (Washington, D.C.: CSIS, November 2010), pp. 2, 5.

is evaluated against the industrial components of the MSCI Europe Index.² Data are aggregated for each of the companies in the respective indices to get weighted totals or averages. The financial data are obtained from commercial services and company filings. The appendix to this report lists the ESDS Index companies.

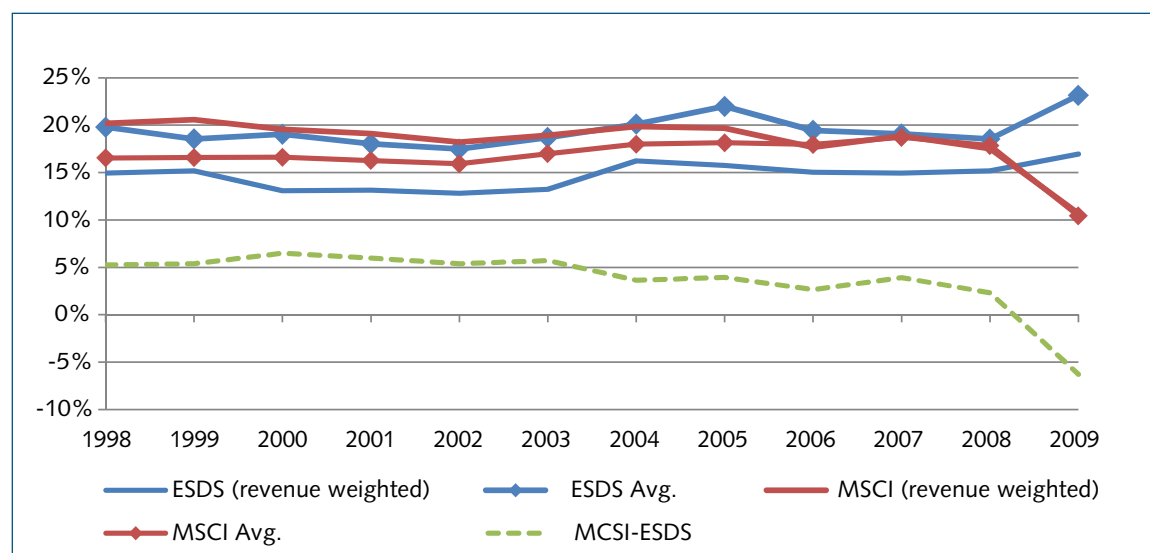
Past Trends: Industry Profitability (through 2009)

In the medium term and long term, profitability is critical to a sector's attractiveness to outside investors. Low profitability relative to other sectors will hinder an industry's ability to attract capital to finance its operations. When profitability shrinks, the industry may contract as well, as companies and capital gravitate toward sectors that are more lucrative. Three profitability measures provide a quick read on comparative industry health: gross margin; operating margin (earnings before interest and taxes—EBIT—margin); and cash flow return on investment (CFROI). By these measures, companies in the ESDS Index have performed well compared to their peers in the MSCI Europe Industrials Index.

Gross Margin

Gross margin is the ratio of gross profit to sales. It is the portion of revenue left after paying the direct cost of goods and services sold. As shown in figure 1, revenue-weighted³ gross margin for

Figure 1. Gross Margins: CSIS ESDS and MSCI Industrials Indices (1998–2009)



Source: Bloomberg; analysis by CSIS Defense-Industrial Initiatives Group.

2. The MSCI Europe Industrials Index is made up of 11 companies varying in activity and scope, primarily capital-goods manufacturers but also representing the service sector. The analyses presented here use historical data for the period 1995 through 2009 for the Index members as of November 2009. MSCI Industrials members Abertis, Société Des Autoroutes, and Atlantia SPA, all of which operate toll roads, are excluded.

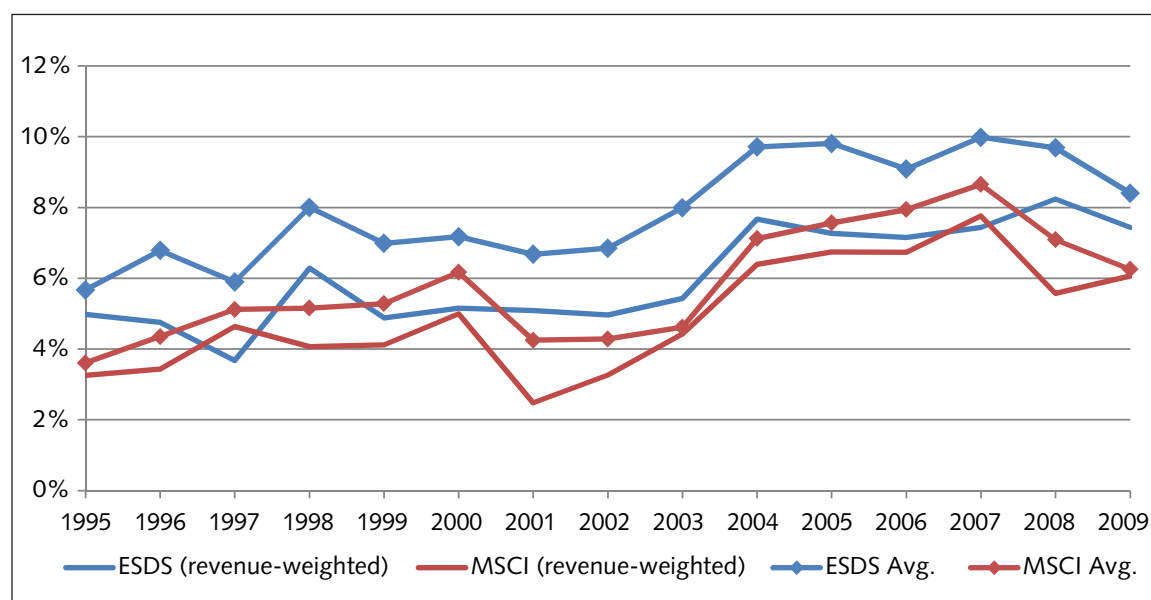
3. Total sum of index gross profits over total sum of index sales; revenue-weighted measures amplify large index companies' (by revenue) effect on a metric.

the ESDS Index has been lower than that for the broader industrial sector. However, the average company in the ESDS Index has a higher gross margin than the average company in the MSCI Industrials Index. This means that smaller defense and security companies tend to have higher gross margins than larger defense and security companies. The spread between revenue-weighted and average gross margin in the defense and security industry attests to the heterogeneity of the industry. Furthermore, it appears that economies of scale are less important in the defense sector than in other industry segments. The opposite is true of the MSCI Industrials, in which larger companies are likely to have slightly higher gross margins. The sharp decline in gross margin for the commercial MSCI Europe Industrials Index in 2008 and 2009 likely reflects the economic recession. This steadiness in gross margin is also reflected in rather constant delta between gross margin of the MSCI Europe Industrial Index and the ESDS Index. The drop starting in 2008 is caused by the decline in gross margin for the MSCI Europe Industrial Index.

EBIT Margin

The earnings-before-interest-and-taxes margin is a widely used measure of operating profitability. On a revenue-weighted basis (figure 2), EBIT margins for the CSIS ESDS and the MSCI Europe Industrials indices were similar from 1995 through 2009. On a per-company average, the CSIS ESDS Index had a higher EBIT margin than the average MSCI Industrial company. As is the case with gross margin, smaller European defense and security companies appear to have higher returns than their larger competitors. Again, economics of scale are less relevant to a company's profitability in the defense and security sector. Operating margins improved for both indices in the early part of the decade, likely reflecting the benefits of higher revenue and an improving overall economic environment.

Figure 2. EBIT Margins: CSIS ESDS and MSCI Industrial Indices, Revenue Weighted (1995–2009)



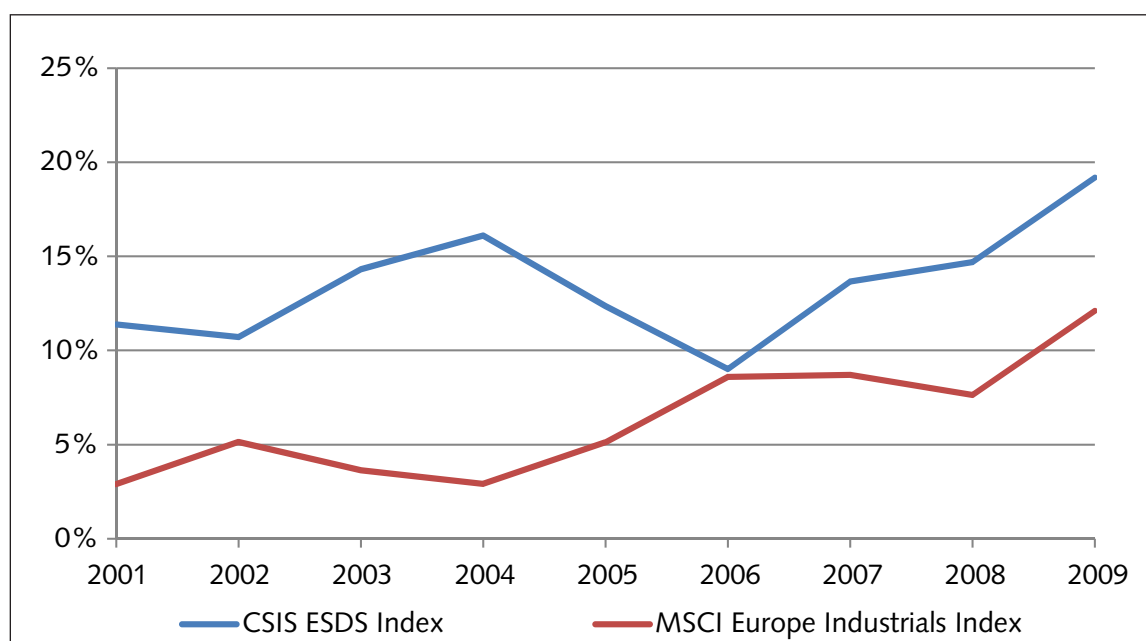
Source: Bloomberg; analysis by CSIS Defense-Industrial Initiatives Group.

Cash Flow Return on Investment (CFROI)

Cash flow return on investment (CFROI) compares the cash available after expenses have been paid—and sufficient investment has been made to continue current operations—to the total investment in the company.⁴ CFROI often drives decisions to enter or exit an industry, meaning it can ultimately shape the breadth and depth of the defense industry and the capabilities it offers.

ESDS Index companies are substantially more profitable compared to other European industrial companies. As shown in figure 3, CFROI for the CSIS ESDS Index has been substantially higher than that for the MSCI Europe Industrials Index between 2001 and 2009 (with the exception of 2006).

Figure 3. CFROI: CSIS and MSCI Industrials, Revenue Weighted (2001-2009)



Source: Bloomberg; analysis by CSIS Defense-Industrial Initiatives Group.

Based on the metrics above, ESDS Index companies were generally at least as profitable as their European commercial peers. Within the defense and security sector, on average, smaller companies reported better results than larger companies. On a cash flow basis, which many investors consider among the most important measurements,⁵ ESDS Index companies performed substantially better than their commercial industry peers during the period evaluated.

4. Cash flow is the sum of EBIT plus depreciation and amortization minus capital expenditures minus the increase in net working capital, which in turn is the sum of accounts receivable and inventory, minus accounts payable. Investment is the sum of long-term and short-term debt and shareholders' equity (including preferred stock).

5. Morgan Stanley, *Aerospace and Defense: 2010 Defense Survey Results and Analysis*, January 11, 2010, confidential source.

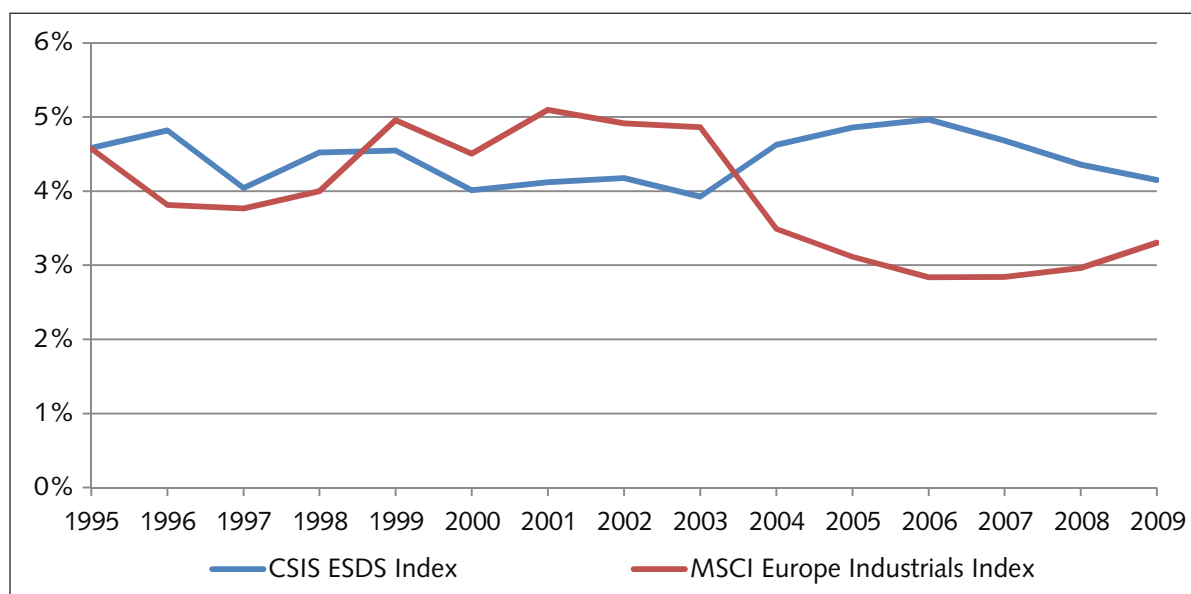
Industry Outlook

While profitability gauges how attractive an industry is to investors, the investment accounts—capital expenditures and research and development (R&D)—provide a perspective on how the industry itself views its market opportunity. Growing investment suggests that industry executives see greater opportunities in their markets, while the opposite suggests pessimism about longer-term prospects. R&D spending indicates the industry’s investment in innovation and the development of next-generation products and services. Capital expenditures (CapEx), in turn, measure the industry’s continuing investment in the assets it needs to remain in business, such as buildings and machinery. Companies in the ESDS Index show investment levels comparable to those reported by companies in the MSCI Europe Industrials Index. While R&D as a percentage of sales has been reasonably steady, capital expenditures have fluctuated.

Research and Development

On average, ESDS Index companies have spent 4 to 5 percent of sales on R&D, a level roughly comparable to that of their counterparts in the MSCI Europe Industrials (figure 4). This suggests a consistent effort to develop new technologies and capabilities. Note, however, that the reported R&D data include government grants, subsidies, and tax credits as well as self-financed activity. The ESDS data therefore represent to some extent the efforts of the relevant governments. In contrast, on the commercial side, R&D as a percentage of sales declined as of 2003, likely because of management deciding that a point had been reached at which more R&D expenditures would not lead to higher profits. For the defense side, the drop in R&D as a share of sales from 2006 onward is the result of increased sales rather than a decrease in R&D.

Figure 4. R&D as Percentage of Sales: CSIS ESDS and MSCI Industrials Indices, Index Average (1995–2009)



Note: Excludes QinetiQ.

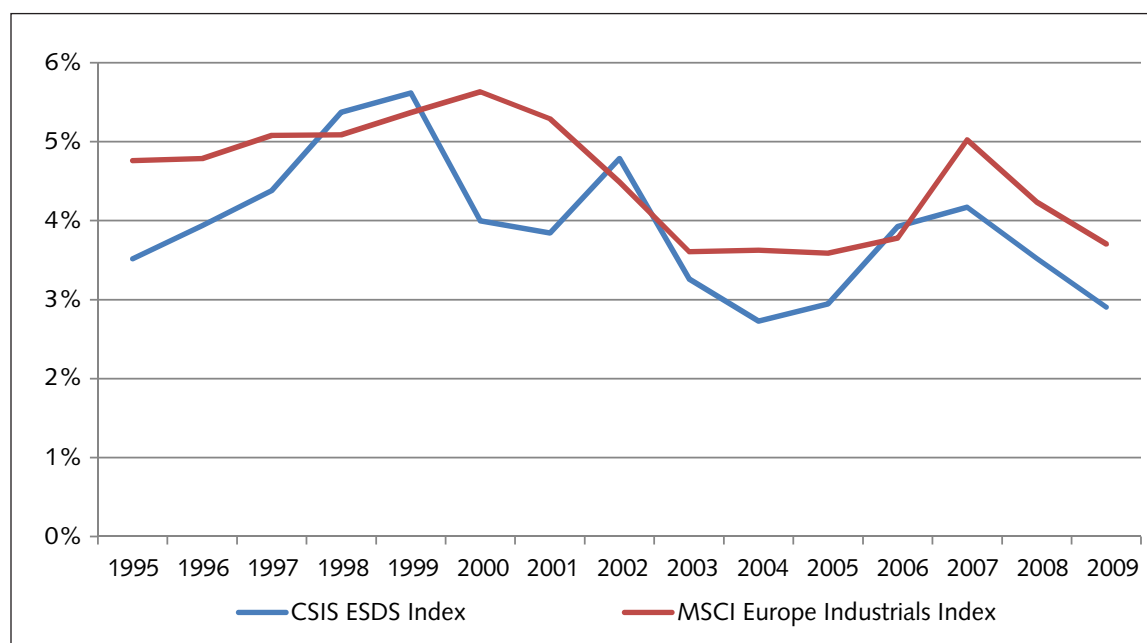
Source: Bloomberg; analysis by CSIS Defense-Industrial Initiatives Group.

Capital Expenditures

On average, companies in the ESDS Index and the MSCI Europe Industrials had similar CapEx levels as a percentage of sales (figure 5). The comparable performance, regardless of changes in sales or overall economic conditions, suggests ESDS Index and MSCI Europe Industrials companies took similar views on the longer-term prospects of their respective industries.

Internal R&D and capital expenditures could serve as a barometer for the vitality of the defense and security sector. If falling margins and cash flows are complemented by decreasing internal R&D and capital expenditures, it may be that companies are becoming pessimistic about their long-term prospects and potentially are preparing to exit the market. In recent years, defense and security companies have invested at levels comparable to those of industrial companies, and government R&D spending has decreased but not dramatically so. This suggests that firms in the European industrial base supporting defense and security are confident about their medium- to longer-term opportunities, or at any rate are as confident as their industrial counterparts are in their own respective markets.

Figure 5. CapEx as Percentage of Sales: CSIS ESDS and MSCI Industrials Indices, Index Average (1995–2009)



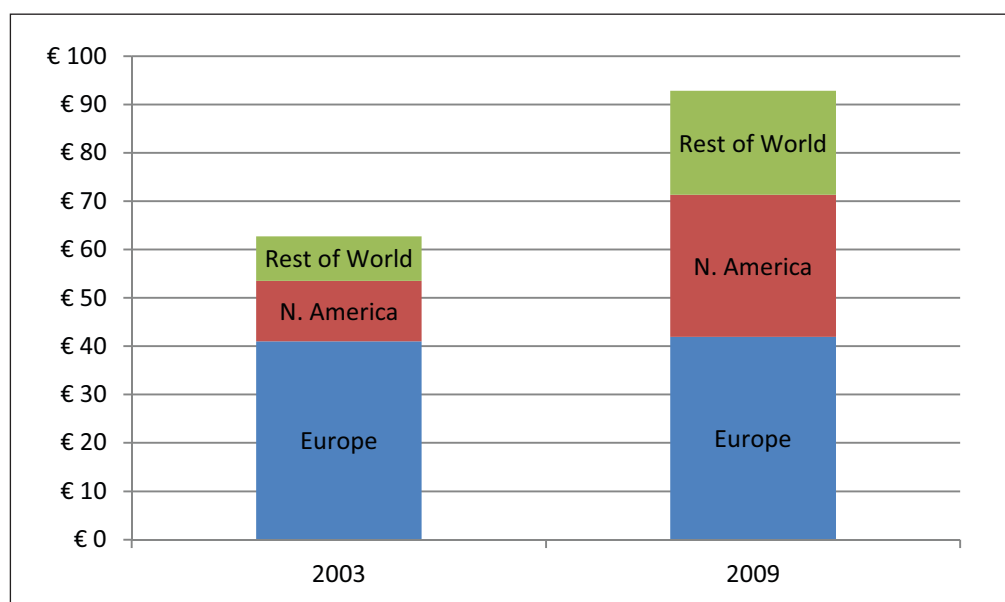
Source: Bloomberg; analysis by CSIS Defense-Industrial Initiatives Group.

Vulnerabilities

Two indicators could shed some light on companies' potential vulnerabilities to economic austerity: geographic exposure and market exposure (pure defense versus a mix of defense and commercial).

CSIS ESDS Index companies' revenue grew from €63 billion in 2003 to €93 billion in 2009 (in constant 2009 euros), a 49 percent gain, despite flat or declining defense budgets in Europe. One explanation is CSIS ESDS Index companies' increasing exposure to foreign markets, especially that of the United States. Figure 6 shows the CSIS ESDS Index revenue mix by geographic origin for 2003 and 2009. Revenue originating outside Europe more than doubled and increased from 35 percent of total ESDS Index revenue in 2003 to 55 percent by 2009.⁶ Revenue from European markets remained virtually unchanged between 2003 and 2009, though its contribution to total ESDS Index revenue fell by 20 percent. This shift in revenue by geographic origin means that European markets are no longer the main revenue source for ESDS Index companies. It also indicates that European defense and security companies are competitive in the global marketplace.

Figure 6. CSIS ESDS Index Revenue Mix by Geographic Origin (2003, 2009 in constant 2009 billion euros)



Note: Excludes European Aeronautics Defense and Space (EADS).

Source: Company filing; analysis by CSIS Defense-Industrial Initiatives Group.

European defense and security companies with a geographically diverse revenue mix will be less vulnerable to European austerity measures. North America will likely remain a key revenue source for European companies in the coming years. However, with U.S. defense budgets facing

6. Excluding European Aeronautics Defense and Space (EADS).

pressure, it is unclear whether European defense and security companies will be able to maintain growth rates comparable to those of the past decade. Firms have ramped up their business development efforts in emerging markets such as Latin America, the Middle East, and India, and the competition for business in these markets will be intense. Russia, which signed a deal for four French Mistral-class amphibious assault ships in January 2011, might be another potential customer for European defense firms, but no additional deals are imminent and it is unclear whether there will be much Russian demand for foreign defense equipment in the coming years. China is an additional potential export market, but given the EU embargo on military sales to the country, the lifting of which requires a consensus of all member states as well as a willingness to accept U.S. ire, European firms are unlikely to view this as a source of revenue growth in the near future.

Unlike their U.S. counterparts, however, European defense and security firms tend to be more diversified between the commercial and defense sectors. From a top-line corporate perspective, European defense and security firms' exposure to commercial markets could offset some of the decline in defense and security spending, and growth in the commercial business units could make up for losses on the defense and security side. At the same time, the existence of commercial business units lowers the barrier for exiting the defense market. Put another way, existing commercial segments will make it easier for executives to shift focus—and capital—from defense to commercial business (though to date none of the ESDS Index companies have done so to a significant extent). This might lead to fewer players in the European defense industrial base, leading in turn to less competition, potentially less innovation, and a loss in capacities. However, the considerable level of government involvement, including the ownership of golden stocks and other equity in many European defense and security companies, might alter some of these market-driven decisions. For example, the announcements in early 2011 by Daimler, the German stakeholder in EADS, that it would off-load 50 percent of its shares prompted the German government to announce it will consider creating a golden share in the company in order to maintain influence on its business decisions.⁷

Conclusion

The European defense and security industrial base has the capacity to develop and produce a wide range of equipment and services, including transformational and operationally relevant ones such as counter-IED capabilities, deployable logistics, C4ISR, cyber, and missile defense.⁸ This capacity exists because European companies have recognized that developing such technologies is important to their competitive position in both defense and commercial markets around the world. Future trends in CapEx and R&D will indicate whether industry's outlook on these market opportunities has changed, based on whether orders are placed in Europe or elsewhere.

The European defense and security industrial base overall remains capable, competitive, and financially healthy. Companies in the European defense and security sector have performed well in recent years, both in absolute terms and compared to their peers in the commercial sector. Aided by protected defense equipment accounts, higher domestic security spending, and increased

7. Vanessa Fuhrmans, "Golden Share' an Option for EADS," *Wall Street Journal*, February 23, 2011, <http://online.wsj.com/article/SB10001424052748703775704576162080985105642.html>.

8. See, for example, Gordon Adams and Guy Ben-Ari, *Transforming European Militaries* (London: Routledge, 2006), pp. 142–143; and Seth Jones, *The Rise of European Security Cooperation* (Cambridge: Cambridge University Press, 2007), pp. 160–176.

defense business abroad, their revenues grew steadily despite largely falling or stagnant European defense spending. Operating margins expanded, in line with operating margins of companies from other sectors, and the ESDS Index defense and security companies continued to generate high levels of cash flow.

Concurrently, the European defense and security industrial base is facing the critical challenge of managing the anticipated further declines in European defense spending. A mitigating factor on the defense spending side is the fact that European governments have over the past years managed to maintain their investment accounts in relative terms despite overall budget cuts as well as increased spending on homeland security. In addition, many European defense and security companies have significant commercial business units that can potentially be enhanced to offset declines in the defense business units.

However, it is unlikely that these trends will continue at a pace that can offset future reductions in defense spending. Furthermore, U.S. defense modernization accounts are likely to fall in the near future. The growth potential of other regional markets over the next five years might also change. For instance, the revolutionary tendencies in the North African region might shift acquisition priorities and preferences for suppliers.⁹ Given the constraining budget environment on both side of the Atlantic, and the low barriers for European firms to exit the defense business, it will be critical for European governments to communicate their requirements clearly to European defense and security companies so that these in turn may most effectively align their portfolios with their customers' priorities.

9. See "Les blues des marchands de canons," *Le Monde*, March 5, 2011.

5

MITIGATING THE IMPACT OF THE CRISIS ON THE TRANS-ATLANTIC PARTNERSHIP

Stephen J. Flanagan and Heather A. Conley

This concluding chapter considers the scope for action in the European and transatlantic contexts that could result in more efficient utilization of available defense and foreign assistance resources to maintain or even enhance certain capabilities.

Balancing Defense Ambition with Austerity

In the face of the projected fiscal austerity, European governments have two basic options in the defense sector: to lower their “level of ambition” and accept they will have reduced military capabilities or to resolve once again to pursue reforms and multinational collaboration to preserve key capabilities and “get best value” from available resources. The first option has proven politically unpalatable for most governments in today’s uncertain global security environment, because it requires a candid prioritization of security threats and admission that it will be accompanied by a higher degree of risk in areas where the country will have diminished defense capabilities. One exception was the UK’s 2010 Strategic Defence and Security Review, which sought to align strategic ambition with resources to ensure the country’s long-term economic health. It called for a recalibration of defense capabilities, but not a sweeping retrenchment from engagement in global security affairs. The SDSR admitted that the transition to the new military posture will create “temporary risks and vulnerabilities” that have to be managed.

In contrast, the 2010 NATO Strategic Concept explicitly calls for maintaining “the full range of capabilities” to deal with an even broader array of threats than the 1999 concept identified. Allies committed to maintaining that level of ambition through more efficient use of resources, and they vowed to do so through more coherent defense planning, multinational development of capabilities, and broad reforms of structures and methodologies. Under pressure from member governments, the Lisbon Summit endorsed a number of reforms to NATO structures, including a 30 percent reduction in NATO military headquarters commands and consolidation of civilian agencies (from 14 to 3), as well as other measures to enhance efficiency.

In an effort to reconcile the level of ambition with fiscal realities, NATO Secretary General Rasmussen has called for “Smart Defense” to get more from available resources through pooling and sharing of capabilities, setting the right priorities, and better coordination of national defense plans within NATO to ensure coherence among the projected military postures of allied governments.¹

1. NATO Secretary General Anders Fogh Rasmussen, “Building Security in an Age of Austerity” (key-note speech, 2011 Munich Security Conference, February 4, 2011), http://www.nato.int/cps/en/natolive/opinions_70400.htm.

Defense: A Cooperative Imperative?

The fact that all European governments face the challenge of preserving critical defense capabilities in this prolonged era of austerity has led many to assume a “cooperative imperative.” Under the familiar mantra of “never waste a good crisis,” the economic situation seems to offer a good opportunity to overcome past barriers and move toward “rationalizing defense spending rather than toward demilitarization of Europe,” as former EU High Representative for Common Foreign and Security Policy and former NATO Secretary General Javier Solana has suggested.² Initiatives like the 2010 UK-France Defence Co-operation Treaty suggest that there may be some political momentum behind further defense integration. As is being argued, “the fact that this [such cooperation] has been moved beyond the realm of wild speculation and is indeed considered imminent by most serious observers is a testament to the sea change that’s occurred.”³

Unfortunately, most countries are pursuing sharp reductions on a purely national basis with no reference to NATO or EU obligations or consideration of the overall coherence of the residual posture. Concept papers for burden sharing and pooling are being discussed, but little concrete progress has been achieved to date. There is a clear risk that the scarcity of defense investment resources will lead states to “fall back to their traditional behavior of finding purely national solutions, perhaps driven by protecting national industrial interests... The consequences will be a continued lack of interoperability and standardization, duplication of even scarcer resources, and less instead of better capabilities.”⁴

There are also limitations to the feasibility of cooperation. The degree to which countries are affected by the crisis varies greatly and national austerity measures are affecting militaries in very different ways. As outlined in the CSIS DIIG report, European armies differ greatly in their stage in the transformational process and portray a vastly different degree of deployability, efficiency, and size. The limited transmission of the crisis to defense budgets, combined with traditional service interests, will also mean that national force structures will remain intact in the short term. This is particularly true as procurement for national forces has often been unrealistic and not well correlated to military requirements, as was the case with the original plans of European partners to procure 620 Eurofighters and 180 A400Ms.

Potential cooperation among European states must take into account the heterogeneity of European forces on three levels: Europeans vary greatly in force capabilities, in threat perceptions, and in the role they want their nation to play in the world. Acknowledging the different European levels of ambition is a precondition for cooperation. Europeans vary greatly in what they can do, but also in what they want to do. Such an approach can easily explain the recent Anglo-French defense treaty. Both nations, as part of their historic experience and geopolitical roles, have a greater level of global ambition and national interests than other European nations. London and Paris

2. Javier Solana, “A Window of Opportunity for European Defense,” *Our World in 2011, A New Europe* Special Edition, January 3, 2011, pp. 10–11, <http://neurope.eu/2011/>.

3. Judah Grunstein, “France-U.K. Cooperation and EU Defense Cooperation,” *World Politics Review*, October 15, 2010, <http://www.worldpoliticsreview.com/trend-lines/6734/france-u-k-defense-cooperation-and-eu-defense>.

4. Carlo Magrassi, Deputy Chief Executive–Strategy, European Defence Agency, “Better Spending in Security and Defence” (address at the European Security Foundation Conference on “New Development in ESDP,” Brussels, October 5, 2010).

are also unique in that they both have very well trained and equipped forces backed by healthy defense industrial bases, enabling them to carry out the full spectrum of missions.⁵

Many concerned observers have noted that this type of bilateral collaboration marks a dangerous departure away from European cooperation. However, it has to be acknowledged that this divergence from Permanent Structured Cooperation, rather than being a mere ideological move by a conservative British government, reflects a desire for the practical added value of this concept. Far from a threat to European cohesion, this concept promises to make the two leading European security actors more capable and interoperable.

The NATO Lisbon Summit's commitment to more coherent defense planning faces a number of impediments. The stated goal of NATO's defense planning process is to provide a framework within which national and Alliance defense planning activities can be harmonized to meet agreed targets in the most effective way. In practice, Alliance governments have a long tradition of using the process as a way to prove that various defense planning decisions shaped largely by national preferences and political pressures are consistent with NATO priorities and force goals. In June 2009, NATO defense ministers endorsed a new NATO Defense Planning Process (NDPP) touted as a more coherent and comprehensive approach that will bring the Alliance's civilian and military sides, including the Strategic Commands, into a common, functionally integrated approach.⁶ The NDPP consists of five sequential steps on a four-year cycle with biannual elements, including political guidance, establishing requirements, setting targets, and review of results, with a continuous process of facilitating implementation. A number of seasoned NATO defense planners have observed that the NDPP remains cumbersome and has become too diffuse. NATO planners and many officials in capitals are skeptical that the NDPP can be used to manage and shape the unilateral build-downs in national defense programs to ensure maximum output and complementarity of residual capabilities or to spur multinational cooperation and rationalization. For example, given that the UK SDSR and the German Commission on the Structure of the Bundeswehr were completed just before the issuance of the new NATO Strategic Concept, Alliance coordination efforts will confront the considerable bureaucratic momentum that these plans have already gained.

- This would suggest that another NATO process, separate from but linked to the NDPP, or a consultative mechanism among key allies, is needed to ensure the overall coherence of the residual collective Alliance defense posture as member governments implement various reforms and reductions.

Senior European and NATO officials have recently looked to multinational cooperation as a way to maintain and even enhance military capabilities in the current period of austerity. In March 2010, NATO defense ministers tasked Allied Command Transformation to lead a task force to promote and synchronize ideas for multinational capability development as part of the Smart Defense initiative. Pooling and sharing of capabilities, multinational procurement programs, and role specialization have been tried before with some success, but many more such attempts have

5. For a detailed analysis of this key bilateral relationship, see Etienne de Durand, "Entente or Oblivion: Prospects and Pitfalls of Franco-British Co-operation on Defence," *Future Defence Review*, Working Paper No. 8, Royal United Services Institute, September 2010, <http://www.rusi.org/downloads/assets/FDR8.pdf>.

6. North Atlantic Treaty Organization, "The NATO Defence Planning Process," http://www.nato.int/cps/en/natolive/topics_49202.htm.

proved disappointing with often more costly results. Such cooperation has costs and benefits and faces a number of well-documented political, economic, and industrial impediments. That said, there may be ways to structure future programs to avoid past mistakes.

Bastian Giegerich has offered a cogent assessment of how multinational cooperation has been pursued with respect to the equipping and operating of armed forces:⁷

- Sharing involves making national capabilities temporarily available in a multinational context but without a multinational mechanism governing their use. The seven-nation European Carrier Interoperability Initiative, developed in 2008 to allow nations to contribute assets to a composite carrier strike group in support of NATO or EU operations, is an example of this approach.
- Pooling of national assets to a multinational structure is another mechanism. The 22-nation Movement Coordination Centre Europe coordinates air and sea transport and air-to-air refueling capabilities of participating countries to ensure these capabilities are used efficiently.
- Role and task sharing, where nations rely on partners or a multinational structure for certain capabilities and provide other capabilities, has been pursued with some success. If coordinated properly, this can avoid duplication and give countries access to capabilities they could not otherwise afford. For example, the Czech Republic has chosen to specialize in nuclear, biological, and chemical defense within NATO.
- Cooperation on equipment procurement has been more problematic. The vast majority of defense procurement and research and development programs in Europe are pursued on a national basis. Pooling of acquisitions has proven successful with respect to expensive enablers, such as the NATO AWACS and Strategic Airlift Capability (3 C-17s). Large and complex multinational co-development programs, with differing, and evolving national requirements, such as the A-400M transport aircraft and the NH-90 multi-role helicopters, have proven costly and not met operational requirements. Agreement on requirements and timelines among participating nations is a prerequisite for success in such ventures.

7. For an insightful review of the challenges of defense cooperation in Europe, see Bastian Giegerich, “Budget Crunch: Implications for European Defence,” *Survival* 52, no. 4 (August–September 2010), pp. 87–89.

Avoiding the Pitfalls of Multinational Collaboration

Guy Ben-Ari and Joachim Hofbauer

The theoretical appeal of multinational collaboration in defense research and development and acquisition is strong. Cost savings through economies of scale, better capabilities through knowledge sharing and integration, common logistics, improved interoperability, and stronger political ties constitute convincing arguments in favor of collaboration. Unfortunately, practical experience has not met these expectations. Many multinational collaborative defense programs are plagued by cost overruns and schedule slippages comparable to or greater than those of their national counterparts. Additional layers of bureaucracy, the inability to harmonize requirements, political interferences, funding instabilities due to incompatible budget cycles, and too-frequent changes in management are among the reasons for these undesirable outcomes.

One prevalent feature of the majority of multinational collaborative defense programs is the focus on large, expensive, and platform-based systems, such as the Eurofighter. Such programs, conceived during the Cold War, have arguably outlived their operational purpose, and their continuation is to a large extent fueled by considerations of sunk costs and the desire to preserve jobs and international cooperation as well as contractual obligations. (In many cases, cancelling a program will incur such high fees for the government that it makes more sense to continue it; the UK's *Queen Elizabeth* carrier is a classic example.)

The key question is whether it might be possible to leverage the theoretical advantages of multinational collaboration while mitigating most of the negative outcomes of past programs. We posit that the problems many collaborative programs experience are not a function of their collaborative character, but rather of the program type. Shifting the focus away from large platforms with long development periods toward smaller-scale (though not necessarily less complex) programs in emerging, more operationally relevant domains—such as cyber security, deployable logistics, unmanned systems, alternative fuels, power sources, or autonomous data analysis—may yield better results and draw new players into the defense business. This bodes well for realization of elements of NATO's Critical Capabilities Package, which includes some smaller-scale programs in operational support, C4ISR, and cyber.

Funding stability would be less of an issue for such programs due to their smaller scale. Continuous support from political, military, and bureaucratic leadership would also be less relevant due to shorter program cycles. The danger of adverse political interference would decrease proportional to the lower public visibility these programs would attract. Requirements should be easier to harmonize within a smaller scope, and operators in the field would benefit from shorter times to market. In a budget-constrained environment, collaborative programs will be evaluated even more rigorously on their ability to deliver real cost savings and produce operational capabilities that are superior to solutions developed independently. Smaller-scale, more agile programs should be able to better deliver on these points and therefore create more value than their larger, higher-profile yet less-successful counterparts. This would directly benefit war fighters and taxpayers alike.

Expanded Bilateral and Regional Cooperation

The current austerity measures have placed earlier British and French defense plans and models of defense cooperation in jeopardy. To help maintain their relevance and global reach, the British and French concluded a Defence Co-operation Treaty and a package of joint defense initiatives in November 2010 designed to coordinate and harmonize their defense policies and plans to include more combined units, coordinated research and development and procurement programs, and complementary operational concepts. Although this will at best maintain, not augment, their current expeditionary capabilities, the outcome of UK-France cooperation is likely to shape the future of European defense capability, as its success or failure could shape their thinking on the potential development of the Lisbon Treaty's Permanent Structured Cooperation. As witnessed by the progress made in EU defense integration after the 1998 UK-France St. Malo Declaration on principles of a European defense capacity, the convergence of London and Paris could hold the key to future European integration efforts. Absent the participation of Europe's two most capable forces, such a wider effort would not achieve very much.

Increased defense integration among other groups of European countries is gaining new attention as a way to achieve more efficient use of resources. At a December 2010 meeting the Weimar Group—Poland, Germany, and France—pledged to improve their capacities to plan and to conduct combined operations and to strengthen cooperation among their militaries (including an EU Battle Group to be available in 2013) to create synergies in times of scarce resources. Longstanding defense cooperation among the five Nordic and three Baltic countries to enhance security in northern Europe and the Arctic has also been given new impetus by the economic crisis. At a November 2010 meeting in Oslo, defense ministers from these countries discussed further defense integration through the Nordic Battle Group, additional exercises, joint acquisition programs, and common logistics.⁸ The Nordic and Baltic ministers were joined by their British, Polish, and German counterparts, who noted the value of cooperation with the group at a time of tight budgets. There has also been some discussion among the Visegrád Group—the Czech Republic, Hungary, Poland, and Slovakia—of enhancing defense cooperation among these Central European states. These initiatives, while undertaken outside the scope of EU's Common Defense and Security Policy (CSDP), offer practical steps toward enhancing capabilities and maximizing use of defense resources among like-minded EU members.

Implications for CSDP

While some European officials and analysts talk about reinvigorating the EU's Common Security and Defense Policy in tandem with the ongoing development of the foreign policy mechanisms of the Lisbon Treaty, the economic crisis has added to the list of constraining factors. Even before the 2008 financial crisis took hold, France and other key European governments appeared to have diminished ambitions for CSDP, content not to push it beyond short-term crisis management operations at the low end of the so-called Petersberg tasks. France's decision to resume full participation in NATO's military structures also signaled a recalibration on CSDP, and the current British government has embraced bilateral defense cooperation with France as an alternative to CSDP, which it finds feckless. Given the demands of the International Security Assistance Force (ISAF)

8. Gerard O' Dwyer, "Proposed Nordic-Baltic Pact Gains Steam: Alliance Would Cut Costs, Improve Defense," *Defense News*, November 15, 2010, <http://www.defensenews.com/story.php?i=5043127>.

and other ongoing NATO and CSDP operations, there were very few deployable military or police forces available to European governments.

The 2010 Headline Goal approved in 2004 declared that “the European Union is a global actor ready to share in responsibility for global security.” Member states committed to be able by 2010 “to respond with rapid and decisive action...to the full spectrum of crisis management operations covered by the Treaty on the European Union.” Yet, many of the milestones and benchmarks of the 2010 Headline Goal remain unfulfilled.⁹ As EU governments grapple with the current economic and political crisis and Catherine Ashton focuses on development of the External Action Service, it seems unlikely that 2010 goals for CSDP will be met anytime soon.

One recent proposal that offers some promise for EU capability development is the joint Swedish-German proposal on pooling and sharing referred to as the Ghent Initiative. In a “Food for Thought” paper,¹⁰ the stated goal of this initiative is “to preserve and enhance national operational capabilities—with improved effect, sustainability, interoperability, and cost efficiency as a result.” The paper identifies three tiers of potential collaboration: (1) cooperation on essential national capabilities limited to increasing interoperability in areas like combat forces and intelligence; (2) cooperation on capabilities and support structures in areas like non-deployable support forces and strategic and tactical airlift (pooling) without creating too-strong dependencies; and (3) even closer cooperation where mutual dependency and reliance on European partners is acceptable in areas like military academies and pilot training or capabilities like aerial and maritime surveillance. Such a practical approach still gives European member states the ability to decide which capabilities will remain strictly sovereign while retaining the flexibility to move forward in less politically sensitive areas. Further, it gives individual governments the ability to identify adequate partners for cooperation in specific areas and gives the European Defence Agency and other relevant EU bodies a role in facilitating coordination and identifying any potential opportunities for linking various initiatives. While the theoretical construct of this approach seems practical, its development and implementation seems likely to encounter some familiar hurdles.

The new fiscal austerity is also likely to make EU member states more circumspect with respect to the solidarity clause in the Lisbon Treaty concerning terrorist attacks and disasters and the mutual assistance clauses in the case of an armed aggression by another state. That said, there does seem to be growing interest among a number of European governments in giving new priority to homeland and societal security and resilience. While this trend could be attributed to a European preference to counter terrorism primarily through law enforcement and security services, expenditures for these functions do offer more tangible dividends for citizens and consequently enjoy broader political support than military operations receive.

9. Luis Simón, “The Spanish Presidency and CSDP: Time to Get Serious about the Union’s Military Planning and Conduct Capability,” ARI 33/2010, Real Instituto Elcano, Madrid, February 16, 2010, http://www.realinstitutoelcano.org/wps/portal/rielcano_eng/Content?WCM_GLOBAL_CONTEXT=/elcano/elcano_in/zonas_in/europe/ari33-2010; and Luis Simón and Alexander Mattelaer, *EUnity of Command—The Planning and Conduct of CSDP Operations*, Egmont Paper 41, Royal Institute of International Relations, Brussels, January 2011.

10. “European Imperative: Intensifying Military Cooperation in Europe,” Food for Thought paper on “Ghent Initiative,” Berlin and Stockholm, November 2010, <http://www.robert-schuman.eu/doc/actualites/papsweallpoolsharingnot.pdf>.

The Imperative for Alignment of EU Member State, European Commission, and U.S. ODA

Over the past decade, Europe has honed its international development leadership skills, principally through the G8, as it demonstrates the full range of its soft power. Therefore, Europe will be reluctant to give up its well-earned and preferred global position. But as the reality of imposed or voluntary austerity measures and lackluster economic growth ultimately reduce European official development assistance, aid priorities will be limited and more directly tied to a country's economic or strategic interests. Aid to Africa, and to sub-Saharan Africa in particular, will likely stagnate, meaning that while global aid to the region may continue to rise, it will do so gradually and fall far short of Gleneagles commitments.

The EU and the United States provide approximately 80 percent of the world's ODA.¹¹ As European and American foreign assistance budgets receive closer political scrutiny from parliaments and the U.S. Congress during times of greater austerity, there will be increasing pressure to maximize administrative efficiencies as well as develop enhanced assistance collaboration and cooperation. Known as "Europe's 28th donor," the European Commission contributed €12 billion in assistance in 2009 and is the sixth-largest contributor of global international aid. In recognition of the Commission's major contributing role, the November 2009 U.S.-EU Summit announced that the decade-long defunct High Level Consultative Group on Development would be re-launched as the EU-U.S. Development Dialogue. The focus of the Development Dialogue is on three development pillars: the global health, food security, and climate change initiatives of the Millennium Development Goals. During their November 2010 summit, the United States and the EU committed "to collaboration and coordinated action on development, recognizing that [their] goals and objectives are aligned as never before."¹²

There is much that the United States can learn from Europe about how it programs and implements its ODA activities (e.g., the United States will peer review Dutch ODA in early 2011) despite the fact that administrative and funding processes do not naturally align (e.g., Congress approves annual budgets versus the need to develop multiyear funding for long-term activities). The other critical development actor that is not reflected in bilateral or multilateral ODA policy or amounts—but must increasingly be integrated into the overall development assistance picture—is the increasingly dominant role of the private sector in development. Moving forward, it will be essential to closely engage the private sector in a significant collaborative effort with the public and nongovernmental development actors in order to leverage an increasingly diverse development space.

Conclusion

As President Obama noted in November 2010, the United States does not have another partner in any other region of the world that shares "such a close alignment of values, interests, capabilities, and goals."¹³ Europe will undoubtedly remain Washington's partner of choice for the foreseeable

11. Ibid.

12. EU-U.S. Summit Joint statement, Lisbon, November 20, 2010, http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/EN/foraff/117897.pdf.

13. Barack Obama, "Europe and America, Aligned for the Future," *New York Times*, November 18, 2010, <http://www.nytimes.com/2010/11/19/opinion/19iht-edobama.html>.

future. However, with the financial crisis likely to accelerate the long-term trend of diminishing European defense capabilities and to extend it to foreign assistance, doubts in the United States about Europe's overall effectiveness as a full, global partner could lead to new strains in transatlantic relations during a volatile period in world affairs. European and U.S. leaders will need to develop a sustainable and more equitable division of labor for advancing their mutual interests in this era of austerity.

With a healthy defense industrial base, a cadre of operationally experienced military forces, its status as a world leader in soft power, and the prospect of greater policy coherence under the Lisbon Treaty, Europe has the tools required to play a larger role in world affairs. How European governments respond to the economic crisis and the changing demands of global leadership will reveal a great deal about their cohesion and commitment to the European project.



ACRONYMS AND ABBREVIATIONS

ALTBMD	Active Layered Theater Ballistic Missile Defense (NATO)
C4ISR	command, control, communications, computers, intelligence, surveillance, and reconnaissance
CapEx	capital expenditures
CBRN	chemical, biological, radiological, and nuclear
CFROI	cash flow return on investment
COIN	counterinsurgency
CSDP	Common Security and Defence Policy (EU)
DAC	Development Assistance Committee (of OECD)
DFID	Department for International Development (UK)
EBIT	earnings before interest and taxes
EADS	European Aeronautics Defense and Space
EDA	European Defence Agency
EFSF	European Financial Stability Facility (Luxembourg company)
ESDP	European Security and Defence Policy (former term for the CSDP)
ESDS	European Security, Defense, and Space (Index) (CSIS)
EU-27	the 27 member states of the European Union
FRES	Future Rapid Effects System (UK)
GDP	gross domestic product
GNI	gross national income
IED	improvised explosive device
ISAF	International Security Assistance Force
LDCs	least-developed countries
MDGs	Millennium Development Goals
MEADS	Medium Extended Air Defense System
MRTT	multi-role tanker and transport
NCOs	noncommissioned officers
NDPP	NATO Defense Planning Process
ODA	official development assistance
PAA	Phased Adaptive Approach (U.S. missile defense plan for Europe)
SAC	Strategic Airlift Capability (NATO)
SDSR	Strategic Defence and Security Review (UK)
UAVs	unmanned aerial vehicles
UOR	Urgent Operational Requirements (UK)



APPENDIX

COMPANIES IN THE CSIS ESDS INDEX

Babcock International Group	United Kingdom
BAE Systems	United Kingdom
Chemring Group	United Kingdom
Cobham	United Kingdom
Comrod Communication	Norway
Dassault Aviation	France
Finmeccanica	Italy
Indra Sistemas	Spain
Lubawa	Poland
Meggitt	United Kingdom
OHB Technology	Germany
QinetiQ Group	United Kingdom
Rheinmetall	Germany
Roll-Royce Group	United Kingdom
SAAB	Sweden
Safran	France
Serco Group	United Kingdom
Simrad Optronics	Norway
Thales	France
Ultra Electronics	United Kingdom
VT Group	United Kingdom
Zodiac Aerospace	France

Note: The CSIS ESDS (European Security, Defense, and Space) Index is discussed in detail in chapter 4 of this report.



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