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Implications of European Integration for Allies' Defense Spending

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The Honorable Ted Stevens
Chairman
The Honorable Daniel Inouye
Ranking Minority Member
Subcommittee on Defense
Committee on Appropriations
United States Senate

Europe is being affected by a number of changes, including the enlargement of the North Atlantic Treaty Organization (NATO), the adoption of a common currency, and the planned enlargement of the European Union (EU). Concerned about Europe's ability to share in the cost of providing a common defense through NATO, you asked us to assess how European Economic and Monetary Union (EMU) and the enlargement of the EU may affect U.S. allies' ability to sustain or increase their defense budgets. As agreed with your office, this report provides information and analysis concerning (1) projected defense spending for several European countries, (2) budgetary effects of EMU implementation and EU enlargement, and (3) other significant factors that may affect countries' ability to share in the costs of NATO over the long run.[1]

To address these issues, we collected and analyzed information from the U.S. Departments of Defense, State, and the Treasury; and from NATO, the EU, the International Monetary Fund (IMF), the World Bank, the Organization for Economic Cooperation and Development (OECD), the European Central Bank (ECB), and several research organizations. Our work focused on seven European countries--the four West European members of NATO that collectively accounted for over 75 percent of total European NATO defense spending in 1998 (Germany, France, Italy, and the United Kingdom [U.K.]), and the three newest members of NATO (the Czech Republic, Hungary, and Poland). We collected and analyzed information from government officials and private sector analysts in these countries. We visited each of these countries except France, which is not

[1]We have ongoing work reviewing the progress made by our European allies in changing their military forces to meet the requirements of NATO's Strategic Concept, and will report its results later this year.

part of NATO's integrated military command. (See app. IV for a detailed description of our scope and methodology.)

Results in Brief

The United States' security strategy depends on the ability of its allies to join in military operations. This ability includes being able to train and equip forces to meet certain requirements. Although EMU requirements for additional deficit reduction are likely to mean tighter budgets, NATO's West European member countries generally plan to maintain their defense budgets at roughly constant levels through 2002. EMU's budgetary constraints may be offset over time by fiscal benefits and economic growth. A large number of observers are optimistic about EMU's effects on economic growth, but concerns remain. The costs and budgetary impacts of EU enlargement are not readily identifiable, since several key political decisions regarding the timing and specific requirements of membership have not been made. However, these costs are likely to fall largely on prospective, not current, EU members.

Over the long term, defense spending will face increasing pressure as Europe attempts to deal with a number of domestic social issues, in particular escalating entitlement burdens. Spending for public pensions, for example, is already near or above 10 percent of gross domestic product in France, Germany, and Italy—more than twice the U.S. percentage—and is projected to begin to increase sharply in 10-20 years as populations age. Governments' spending for health care is also expected to rise, increasing the budgetary pressures from coming demographic changes. This budget environment means that member countries are likely to continue to face significant challenges in modernizing their defense forces to meet NATO requirements.

Ultimately, the amount of resources allocated to defense is a political decision, driven substantially by views of military threat as well as other competing budget priorities. If EMU's fiscal constraints require further spending cuts, for example, impacts on defense budgets will clearly depend on policy decisions regarding where those cuts are made. Should EMU and EU enlargement contribute to stronger economic growth in Europe, there will be more budgetary resources to address competing needs. The outcomes from these economic developments and political decisions have important implications for U.S. defense planning.

Background

The NATO military alliance of 19 European and North American countries is supported by its members through several means. First, countries contribute to NATO's three commonly funded budgets, including the civil and military budgets and the budget for funding infrastructure improvements (about $1.6 billion total in 1999). The United States contributes about 28 percent of these commonly funded budgets. Countries also support NATO by maintaining forces and assets that they pledge to NATO through a defense planning process. NATO does not quantify the cost of forces national governments commit to NATO, but one way to measure this contribution is through the level of defense spending.

The EU is a political and economic body of 15 European countries, including 11 NATO members. Member states jointly administer the EU through three major institutions. The European Union Council of Ministers, composed of the governments of the member countries, establishes common EU-wide policies. The European Commission proposes legislative initiatives and implements policies agreed to by the Council of Ministers and the European Parliament. The European Parliament, in tandem with the Council of Ministers, must approve most of the legislation introduced by the Commission before it goes into effect.[2]

EMU is an effort by EU countries to more closely link their economic policies to achieve greater economic cooperation and political integration. The most significant and far-reaching aspect of EMU is the adoption of a common currency known as the "euro." On January 1, 1999, 11 EU countries, including 8 members of NATO, locked the exchange rates of their national currencies to the euro,[3] redenominated their national debt into euros, surrendered control of monetary policy to the European Central Bank, and began using the euro in electronic transactions.[4] (Euro currency will not be circulated until 2002.)

The Maastricht Treaty on European Union, signed in 1992, set forth several economic conditions for countries to join the euro area. These included, in part, reducing general government deficits to 3 percent of gross domestic product (GDP) and showing progress toward lowering general government

[2]Parliament's consent is not required for agricultural price reviews.

[3]There are no procedures for countries to leave the euro area after they have joined.

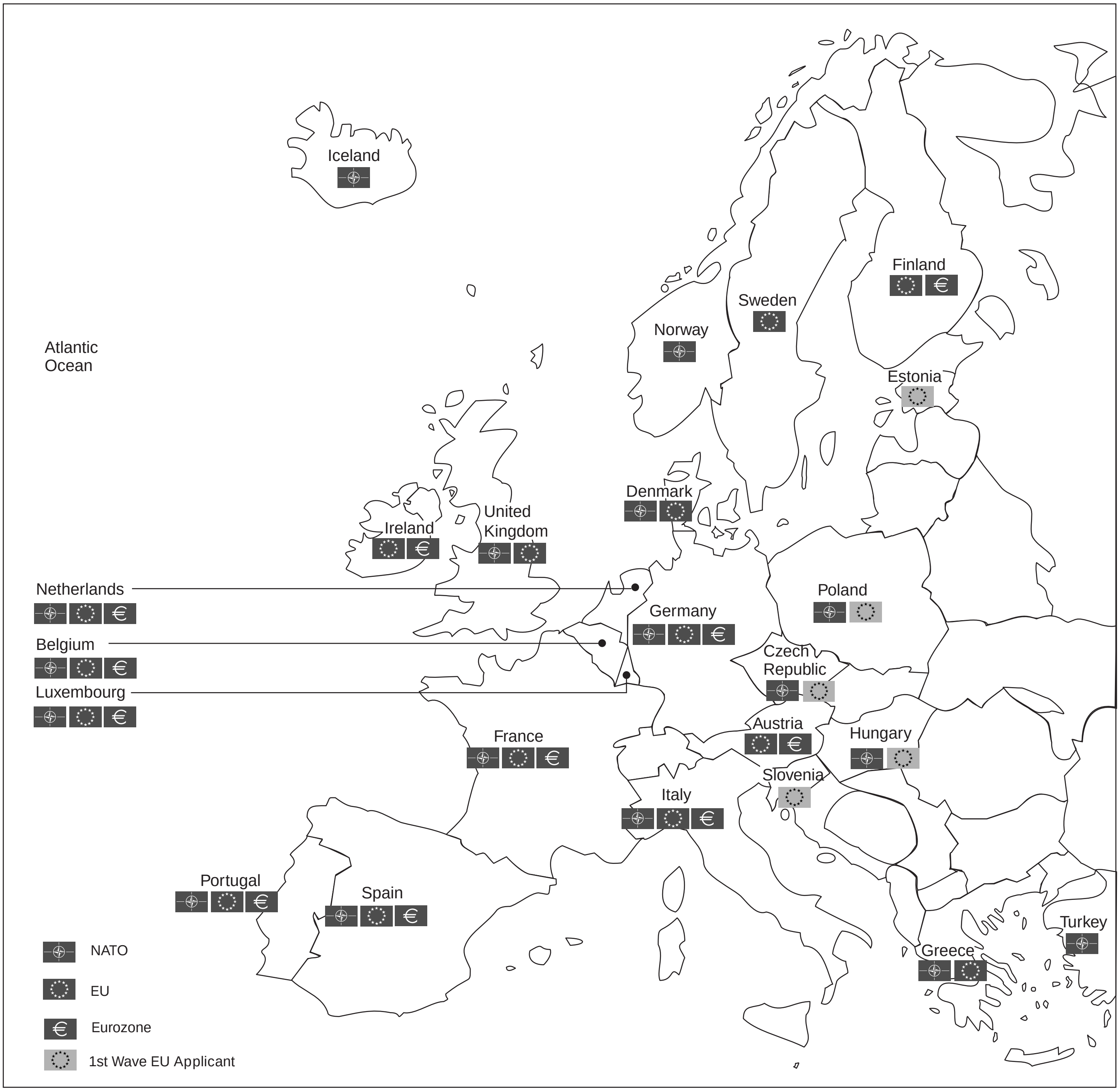
[4]EU countries that chose not to adopt the euro are Denmark, Sweden, and the United Kingdom. Greece wanted to adopt the euro but could not comply with the economic criteria.

debt to 60 percent of GDP.[5] The 1997 Growth and Stability Pact requires countries adopting the euro to further reduce their annual budget deficits and reach the medium-term objective of having budgets close to balance or in surplus. Countries that do not comply with these requirements are subject to sanctions, ranging from public rebuke from the European Council to fines.

In addition to “deepening” European integration through EMU, the EU is also “widening” to include the countries of Eastern and Central Europe. The EU believes that enlarging to Central Europe will help cement peace and stability in the region through developing closer economic and political links. Countries seeking EU membership concur with this potential security benefit and also value the intangible seal of approval EU membership provides.

[5]The Treaty defines “general government” as including Central government, regional or local government, and social security funds. It also requires countries have low inflation, low interest rates, stable exchange rates, and independent central banks compatible with the European Central Bank.

Figure 1: European Members of NATO, the EU, and the Euro Area, and First Wave EU Applicant Countries



In December 1997, the European Council determined that the Czech Republic, Hungary, Poland, and three other countries were in the best position to meet the EU's general economic and political membership criteria.[6] The European Council, the European Parliament, all 15 EU member states, and the applicant country must approve a country's membership before it can enter the EU.

Defense Budget Projections

The four West European members of NATO that we studied plan to maintain their defense spending at roughly constant levels, after adjustments for inflation, through 2002. NATO's three newest members plan to increase defense spending over the period. NATO countries will generally face substantial challenges in modernizing their defense forces within projected budgets, due to high personnel costs, funding needs of large-scale procurements, and costs of ongoing military operations such as in Kosovo. In addition, such ongoing programs as NATO's Defense Capabilities Initiative, as well as the evolving European Security and Defense Identity, could have budgetary implications that cannot yet be determined.

West European Defense Spending Levels off After Post-Cold War Decline

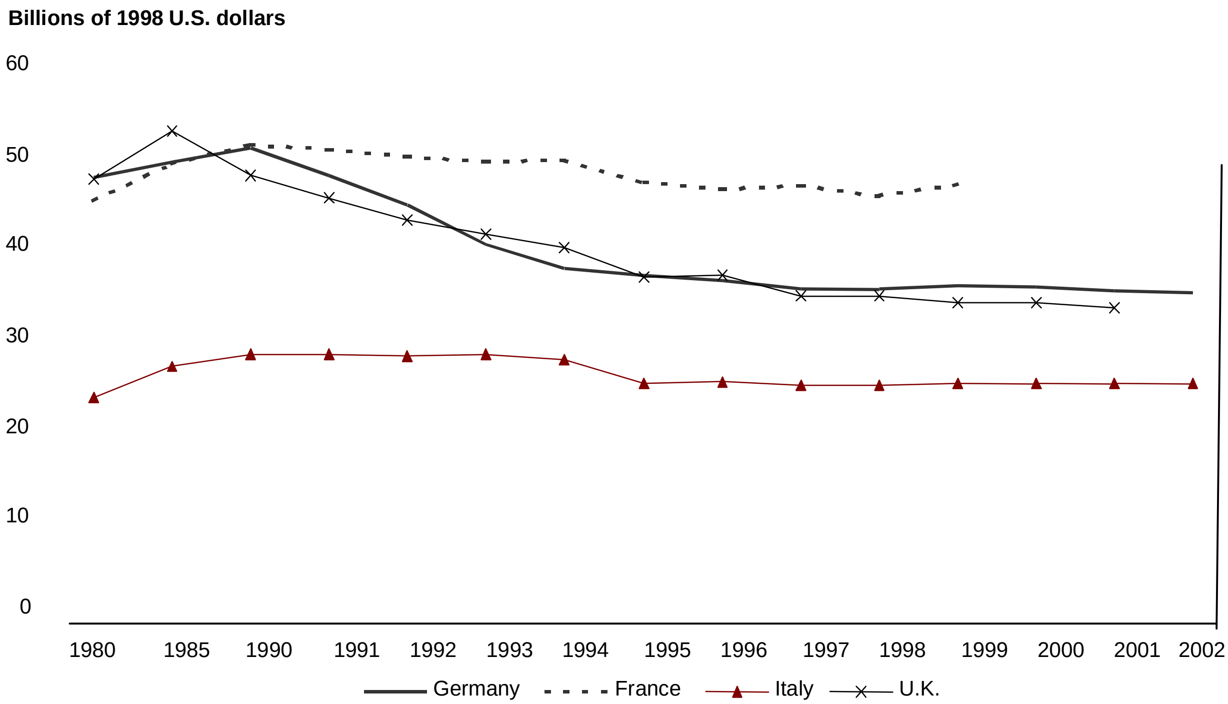
Defense spending levels, adjusted for inflation, have begun to level off in Germany, France, Italy, and the United Kingdom after fairly sharp reductions in the early 1990s. Budget projections of these countries indicate that generally constant defense budgets are planned through 2002, as shown in figure 2. These countries generally could not provide budget projections beyond 2002.

NATO uses a standard definition of "defense expenditure" to facilitate comparison between the defense budgets of NATO-member countries, which differs in some cases from definitions in national budgets. For example, some countries do not include payments toward retirement pensions in their defense budgets, while the NATO definition includes contributions to military pensions but not payments to current retirees. In figures 2, 3, 4, and 5, data from 1980 through 1998 are NATO figures based on its definition of defense expenditure. Since NATO defense budget forecasts are classified information, we calculated projected values using

[6]Cyprus, Estonia, and Slovenia were the other three. The Council decided that it was too early to start bilateral negotiations with Bulgaria, Latvia, Lithuania, Romania, and Slovakia and offered Turkey a "European Strategy," while not including Turkey in the accession process at this time.

defense budget projections from host countries and applied the projected growth rates in defense expenditures to NATO's 1998 spending level for each country.

Figure 2: Historical and Projected Defense Spending in Four West European Countries, 1980-2002



Note 1: Budget projections from 2000-2002 are not available for France; data for 2002 is not available for the U.K.

Note 2: 1998 figures are NATO estimates. NATO will release actual figures in December 1999.

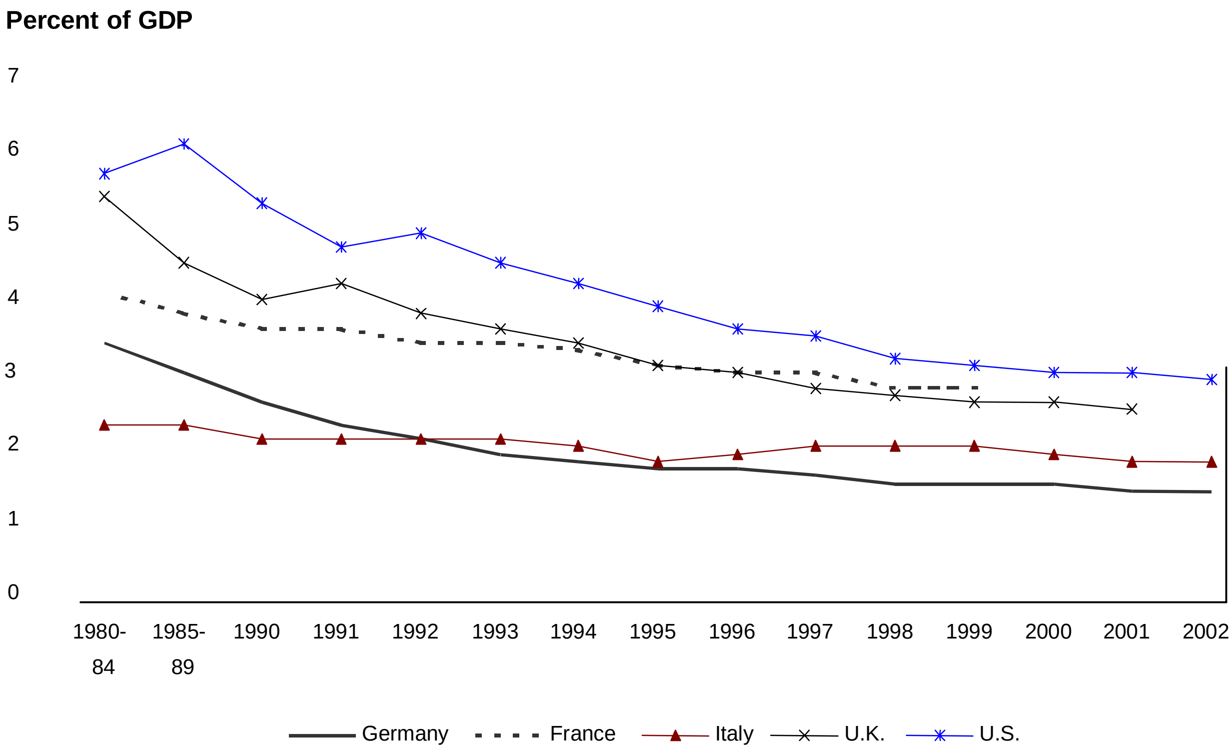
Source: GAO analysis of data from NATO and national ministries of Defense.

The ratio of defense spending to GDP is one measure of the priority countries place on spending for defense relative to that for other national goals. The average defense share of GDP in 1998 was 2.6 percent for all NATO members and 2.1 percent for European NATO members.[7] Using this measure, defense spending in the West European countries we studied has generally fallen steadily since the end of the Cold War, as has that of the

[7]These figures are calculated using constant 1990 prices and exchange rates.

United States. Since planned defense spending is roughly constant and real GDP is projected to grow, defense spending as a percentage of GDP is expected to continue to decline slightly during 1999-2002 for the West European countries we studied (see fig. 3).

Figure 3: Historical and Projected Defense Spending as Percent of GDP for Four West European Countries and the United States, 1980-2002



Note: Budget projections for 2000-2002 are not available for France; data for 2002 is not available for the U.K.

Sources: GAO analysis of data from NATO, national ministries of Defense, and Standard and Poor's DRI (Lexington, MA).

Defense spending in the West European countries we studied has generally been lower over time as a percentage of GDP than that of the United States. This difference, which was particularly significant in the 1980s, continues over the projected period. This is due to a number of factors, according to some European officials, such as different spending priorities, threat perceptions, and views of the determinants of their security. Other officials noted that whereas the United States has a global military presence and interests, European countries generally have focused on European security.

New NATO Members Project Defense Spending Increases

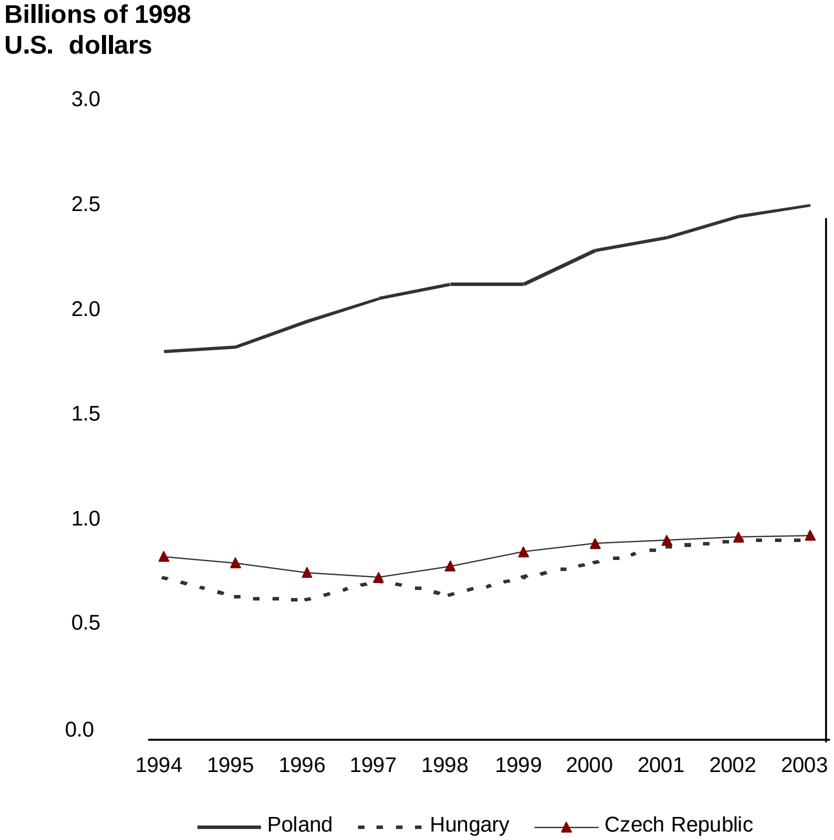
The Czech Republic, Hungary, and Poland plan to increase defense spending during 1999-2003 to modernize their forces and meet NATO requirements. Defense spending declined sharply in these countries as they transitioned from a large Soviet-era defense force to the post-Cold War era,[8] but spending began to increase in the mid-1990s as the countries moved closer to NATO membership.

Figure 4 shows historical and projected defense spending levels for NATO's newest members. Poland's budget shows defense spending in 1999 declining 0.01 percent in real terms from 1998 in part because the Polish government removed military health care costs from the 1999 defense budget. The 1999 defense budget would increase about 2.9 percent in real terms if health care costs were included. Similarly, Hungary's 1999 defense budget includes funding for items that were not included in previous years. When these items are excluded, the budget decreases in real terms between 1998 and 1999, according to the U.S. Department of Defense (DOD).[9]

[8]For example, Poland's 1985 defense spending has been estimated to exceed 8 percent of GDP.

[9]U.S. government officials informed us about these changes in the composition of national defense budgets between 1998 and 1999 for Poland and Hungary.

Figure 4: Historical and Projected Defense Spending in Three Central European Countries, 1994-2003



Note: 1998 figures are NATO estimates. NATO will release actual figures in December 1999.

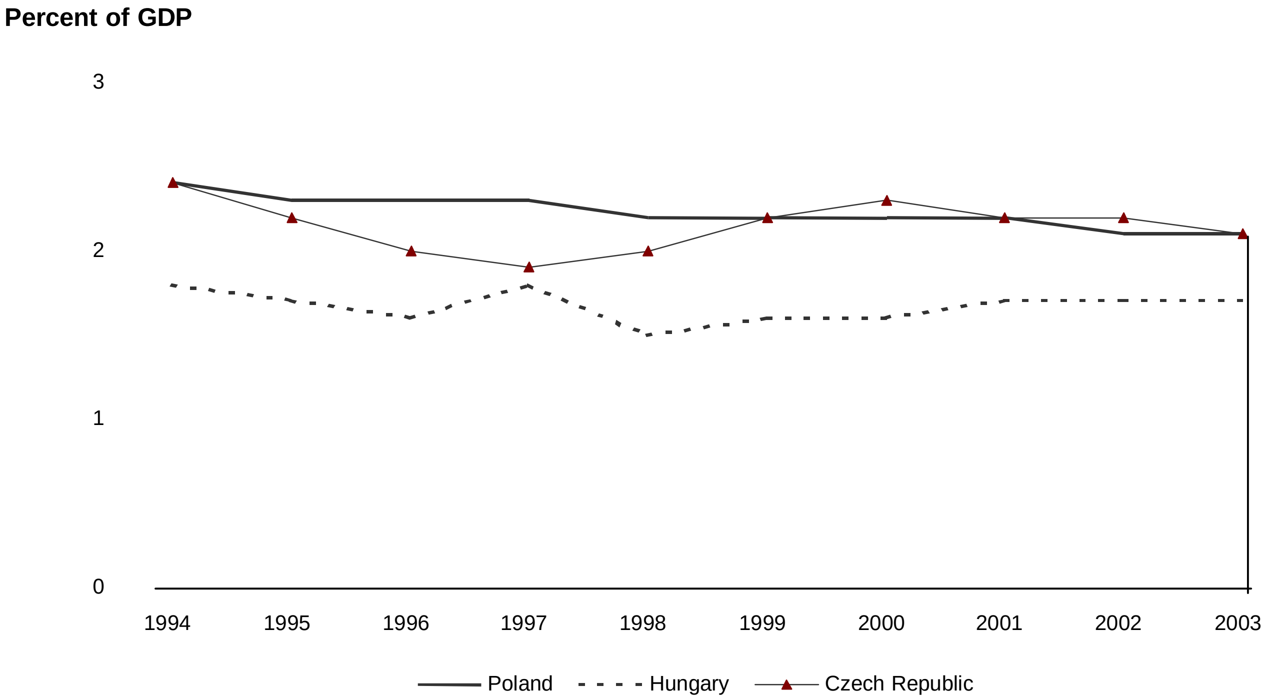
Sources: GAO analysis of data from NATO and national ministries of Defense.

The Czech Republic, Hungary, and Poland have pledged continued defense spending increases until they reach the NATO-Europe average of defense spending as a percent of GDP of 2.1 percent.[10] While Poland is currently above that average share, projections show that defense spending will fall below that share by 2003. In 1998, based on NATO's definition of defense spending, the Czech Republic spent an estimated 2 percent of its GDP on

[10]The Czech Republic and Hungary pledged to increase the defense budget's share of GDP by 0.1 percent each year. Hungary's intermediate goal is to reach 1.8 percent of GDP by 2001.

defense, Hungary 1.5 percent, and Poland 2.2 percent.[11] Figure 5 shows projected defense spending as a percentage of GDP for the new NATO members.

Figure 5: New NATO Members' Defense Spending as a Percentage of GDP, 1994-2003



Sources: GAO analysis of data from NATO, national ministries of Defense, and PlanEcon (Washington, D.C.).

While the three new NATO members met their 1999 defense budgetary commitments, they had some difficulty in doing so as a result of lower than expected economic growth and other domestic budgetary priorities. In Poland, officials told us they planned to spend more on defense in 1999 but could not, in part, due to numerous domestic reforms requiring increased funding. However, they stated that defense spending in the year 2000 and beyond would be consistent with their planned funding objectives. According to Hungarian officials, funding for defense had to be balanced with social spending priorities to avoid creating social tensions and

[11] Figures for 1998 are NATO estimates. NATO will release actual figures in December 1999.

political instability. U.S. embassy and DOD officials were concerned that Hungary's 1999 defense funding difficulties may continue in later years even though NATO requirements would continue to grow. Given the experiences of 1999, U.S. government officials we interviewed expressed some concern about future defense budgets for these countries. They indicated that to meet NATO's target force goals and make other needed changes, consistent spending increases are necessary.

New Security Challenges Affect Spending Needs

The international security environment presents a diverse set of challenges very different from those of the Cold War. NATO's new Strategic Concept adopted at the Washington Summit in April 1999 recognizes changes in threats confronting member nations and calls for new military capabilities.[12] This concept stresses that NATO members' military forces need to be more mobile, flexible, interoperable, and sustainable than in the past. According to NATO, this means, for example, developing capabilities for command, control, communications, intelligence, and surveillance. These requirements, and others, were laid out at the Washington Summit, in NATO's Defense Capabilities Initiative. A NATO steering group has been established to oversee the implementation of the initiative, the budgetary effects of which cannot yet be determined.

Some countries have acknowledged these needs in conducting or planning their own defense reviews. Between 1996 and 1998, the United Kingdom and France issued comprehensive defense reviews that reassessed their security interests and defense needs. They concluded that modern, high-quality defense forces can be created without requiring large increases in defense spending by rigorously setting spending priorities and making difficult choices. These include reducing personnel and other support and operating costs, postponing or canceling certain procurement programs and, in the case of the United Kingdom, selling unneeded assets and facilities. Germany has just begun an extensive defense review along similar lines. Some of the same issues have emerged in defense assessments conducted by the three new NATO members as they adapt their forces to Western standards. European officials have stated that improving their defense capabilities is essential for implementing the

[12]NATO's 1999 Strategic Concept identifies a variety of military and nonmilitary risks that are multi-directional in nature and often difficult to predict. These include: regional instability and the resulting risk of crises; the proliferation of nuclear, biological, and chemical weapons; the spread of potentially dangerous technology; the threat of terrorism, sabotage, and organized crime; and the uncontrolled movement of large numbers of people, due in some cases to armed conflicts.

European Security and Defense Initiative, intended to give European countries the ability to take military action in cases where NATO as a whole is not militarily engaged. They confirmed this position at St. Malo, France, in December 1998 and, in June 1999, the EU member states agreed on the need for capacity for autonomous military action, which requires having a credible force and the readiness to use it.

Competing Needs Present Challenges for Defense Budgets

The countries we studied face considerable challenges as they try to balance competing needs within defense budgets. DOD officials told us that prioritizing defense needs is one of the key challenges facing NATO countries as they seek to modernize and restructure their forces. However, shifting priorities within defense budgets can be difficult. For example, personnel costs represent a large portion of defense spending in several countries, such as 60 to 70 percent in Germany, Italy, and Poland, which have traditionally relied on conscription to staff their armed forces. These countries are currently examining the cost, as well as other implications, of reducing their reliance on conscription. In addition, planned procurements of major items such as the West European aircraft, the Eurofighter, can consume large portions of countries' procurement budgets. Finally, out-of-country deployments, particularly in Bosnia and Kosovo, are requiring significant budgetary resources in the NATO European countries we studied. Combined with the expense of large aircraft purchases and high personnel costs, these operations are affecting the ability of NATO countries to carry out restructuring and modernization, according to foreign officials and U.S. embassy officials. According to DOD and foreign government officials, the efforts of the Czech Republic, Hungary, and Poland to modernize and reorganize their defense structures are made more difficult by limitations in the defense planning and management capabilities needed for effective resource allocations. (See app. I for additional information on defense modernization challenges.)

In addition to the costs of military operations, addressing regional instabilities is expected to have other budgetary effects for EU member countries. In particular, they have committed to funding the major portion of the costs of reconstruction operations in the Balkans, although the specifics regarding funding levels and sources have not yet been established.

Consequences of EMU and EU Enlargement for Defense Spending

EMU and EU enlargement's impacts on defense spending depend on both direct effects on national budgets and how these institutional changes will affect the European economy over the long run. The EMU's requirement for countries to limit deficits and debt will continue to constrain government spending options. At the same time, the enhanced integration brought about by the euro can have positive effects on economic growth that may offset fiscal constraints and provide greater budget flexibility over the longer term. While EU membership may bring economic benefits to new entrants, meeting membership criteria will impose significant costs. The magnitude of these costs and thus their budgetary impact depends on several key political decisions that have not yet been made, such as the timing and specific requirements of membership. Applicant countries are likely to bear most of these costs.

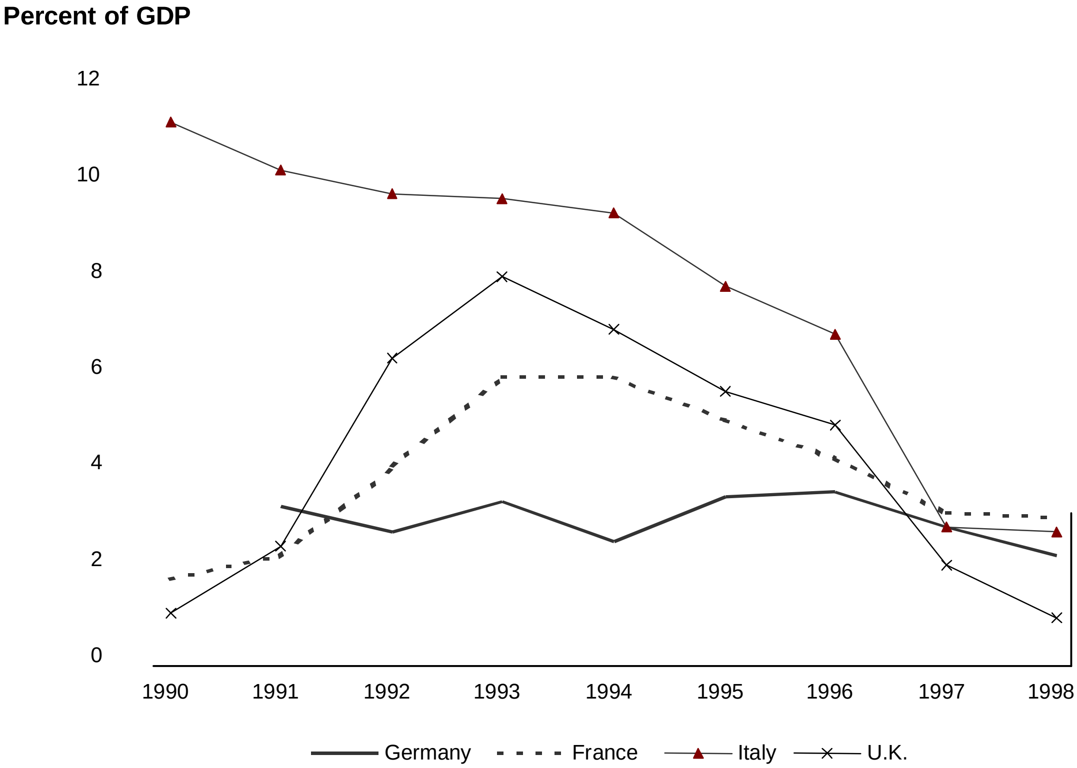
EMU's Implications for Defense Spending Remain Uncertain

EMU has no direct effect on defense spending, but it can affect the availability of national resources for defense spending depending on how the euro and its related requirements influence budgets and economic growth. Adopting the euro constrains national spending, because countries are required to attain roughly balanced budgets in the next few years. The degree to which this will require cuts in government spending depends in part on economic growth in euro area countries**.** EMU's impact on economic growth remains uncertain. A key determinant will be how national economies restructure in reaction to the enhanced competitive pressures from EMU.

Significant Deficit Reductions Achieved, but Further Cuts Required

The fiscal requirements associated with EMU have resulted in significantly lower budget deficits throughout the EU and will require further reductions among those countries that have adopted the euro. Since the early 1990s, countries have significantly reduced their national deficits through a combination of spending cuts and tax increases. (See fig. 6.) For example, between 1994 and 1997, Italy reduced its deficit from 9.2 percent to 2.7 percent of GDP.

Figure 6: Annual General Government Deficits for Four West European Countries as Percent of GDP, 1990-98



Source: European Commission.

Countries can achieve required deficit- and debt-to-GDP ratios by cutting spending, raising taxes, or as a result of increases in GDP. According to the OECD, countries have so far achieved compliance with EMU requirements largely through raising taxes; cutting investment spending and subsidies; and implementing a series of one-time measures that included Italy's euro-tax, and, in some countries, the postponement of certain expenditures 1 week into 1998. In the case of Italy, significant spending reductions have also been achieved through decreased debt service payments due largely to lower interest rates.[13] Table 1 shows the combination of spending cuts and revenue increases used to meet deficit criteria for several countries.

[13]Italy's long-term yield on government bonds, a measure of the cost of government borrowing, dropped from 11.88 percent in 1992 to 6.85 percent in 1997.

Table 1: Sources of Deficit Reductions in Four West European Countries as a Percent of GDP, 1990-97

Country	Changes in spending	Changes in revenue
Germany	-0.3	2.0
France	1.7	2.5
Italy	-5.0	4.8
United Kingdom	-2.0	-0.1

Note: The OECD data calculates changes in various spending and revenue categories as a percentage of the country's potential GDP over the 1990-97 period. Spending includes government transfers as well as other types of spending. The OECD did not specify the breakdown of government spending cuts across functional categories.

Source: GAO analysis based on OECD data.

Countries within the euro area must make additional reductions in both debt and deficit levels over the next few years to comply with the provisions of the 1997 Growth and Stability Pact. Although 1998 debt levels in France, Germany, and the United Kingdom were near or below the required 60 percent of GDP, Italy's debt was 118 percent of GDP. While this represents progress from the peak debt level of 125 percent of GDP attained in 1994, Italy must continue to show progress in reducing government debt to 60 percent of GDP to remain in compliance with EMU requirements.[14] In addition, as table 2 shows, all four EU countries studied plan to continue to cut deficits to comply with Stability Pact deficit requirements, although three of the four countries plan to cut deficits at a slower rate over the next 4 years than was achieved from 1994 to 1998.

[14]The relationship between deficit- and debt-to-GDP ratios is complex and depends on factors such as GDP growth rates, inflation, and interest rates on outstanding debt. In general, high-debt countries will face greater fiscal constraints than low-debt countries. For example, to bring debt below 100 percent of GDP by 2003, Italy plans to have general government revenue exceed general government expenditures, except for debt service payments, by 5.5 percent of GDP.

Table 2: General Government Deficit for Four West European Countries, Selected Years, as a Percent of GDP

Country	1994 deficit	1998 deficit	Planned 2002 deficit
Germany	2.4	2.1	1.0
France	5.8	2.9	0.8 to 1.2
Italy	9.2	2.6	1.0[a]
United Kingdom[b]	6.8	0.8	0.2

[a]Italy's plans are for 2001.

[b]The United Kingdom chooses to abide by the euro area's fiscal constraints.

Source: European Commission.

Achieving further deficit reduction over the medium term may prove difficult for some euro area countries. Countries have made limited progress in reducing deficits since 1997, and budget plans promise little improvement in the near term, according to the IMF. OECD officials told us that many European governments were suffering "fiscal fatigue" from the effort to meet euro area deficit requirements and did not continue to cut spending in 1998 to reduce deficits. In March 1999, the European Central Bank issued a report criticizing governments for this slowdown in deficit reduction and for assuming that sustained economic growth and low interest rates would bring compliance with EMU requirements without further cuts in government spending. The European Central Bank, the OECD, the IMF, and the European Commission have expressed concern that, in the event of a severe or prolonged slowdown in economic growth, government deficits could fail to meet Stability Pact requirements or could even exceed the 3-percent deficit limit. According to European officials, this would reflect badly on the credibility of EMU and could trigger a political crisis if countries were required to pay the fines for non-compliance spelled out in the Treaty on European Union.

While discussion of EMU's fiscal requirements focuses on constraining government spending, the requirements also have beneficial economic and fiscal effects. European Central Bank officials have stated that the lower deficits and debt brought about by EMU will create a more stable economic environment and contribute to greater economic growth in the future. We have also reported on the potential benefits to economic growth of lower deficits.[15] In addition, as Italy's case shows, reducing deficits can also lead to lower interest rates on sovereign debt and thus reduced government spending on debt service. Moreover, reductions in debt levels over time also directly lower debt service costs. Lower interest payments and levels of debt will increase budgetary flexibility making resources available for other policy priorities.

If EMU's deficit requirements require further spending cuts, impacts on defense budgets will clearly depend on policy decisions of individual governments regarding where those cuts are made. We heard a range of views from officials and analysts regarding the potential impact of further budget tightening under EMU. Several officials told us that defense budgets had already been affected by deficit reduction measures to date in several countries. Other officials stated that because current defense spending levels are low by recent historical standards, they are unlikely to be cut further. Many officials and analysts stressed that it is hard to develop a causal link between deficit reduction requirements and changes in a particular category of spending, since a number of factors are involved, including political priorities and rates of economic growth. For example, during the 1990s, Italy cut its general government deficit the most and its defense spending the least, among the countries we studied.

EMU Should Benefit Economic Growth, but Concerns Remain

EMU has broad and important effects on several aspects of European economies, including competitiveness, structural reforms, and the ability of national governments to react to economic downturns. The impact of EMU on economic growth in Europe depends on how EMU affects these and other economic factors. On balance, analysts are guardedly optimistic about the implications of EMU for Europe. However, concerns remain about how EMU will affect the ability of national governments to adjust to economic downturns and derive political consensus to pursue structural reforms. Officials at the IMF, the EU, and the OECD told us they believe that EMU will ultimately boost economic growth in Europe but have not quantified this expected impact.

Optimists believe that, in addition to providing economic benefits from lower deficits, EMU will tie the countries of Europe closer together,

[15]Economic growth requires investment, which over the longer term, depends on savings. Government deficits represent dissavings since they use funds that otherwise could be used for investment. For examples of our work in this area see Budget Issues: Analysis of Long-Term Fiscal Outlook (GAO/AIMD/OCE-98-19, October 22, 1997) and Budgetary Policy: Prompt Action Necessary to Avert Long-Term Damage to the Economy (GAO/OCG-92-2, June 5, 1992).

increase their prosperity, and ultimately improve security through the beneficial effects of integration. Since national governments will no longer be able to adjust to downturns through monetary or exchange rate policy, and the use of fiscal policy will be constrained, they will have to rely on structural reforms, such as revising their policies to increase labor mobility, to address economic problems. Economic efficiency and growth will increase because countries in the euro area will have no choice but to allow increased flexibility in labor, capital, and goods and services markets to stay economically competitive.

Skeptics fear that EMU will create longer, deeper recessions in parts of Europe and possibly increase political tensions between countries if workers and firms move across national boundaries. They believe EMU will ultimately not work because national governments will lack the political support to maintain balanced budgets and undertake unpopular economic structural reforms, such as making it easier for businesses to fire workers. (See app. II for a further discussion of the mechanisms through which EMU can affect economic growth.)

The link between increased economic growth and countries' defense budgets is, of course, an indirect one. In general, stronger growth leads to more resources for all spending needs, including defense, and weaker growth can squeeze many budgetary categories. However, changes in the level of defense spending over time solely due to changes in economic growth can be relatively small. For example, holding assumptions about military threat and political support for defense spending constant, if GDP growth increased (decreased) by 1 percentage point per year relative to baseline projections, it would take about 5 years for real defense spending to increase (decrease) by 5 percent.[16]

EMU's impact on economic growth within the euro area also has important economic consequences for the newest NATO members. For example, exchange rates of the Polish and Hungarian currencies are determined by the values of "currency baskets" that include the euro. In addition, the Polish, Hungarian, and Czech economies depend heavily on trade with the countries in the EU.

[16]This assumes the defense share of GDP declines slightly over the period, based on existing defense budget projections for the countries we studied.

EU Enlargement's Budgetary Impact Uncertain, but Effects on New Member Countries Likely to Be Greatest

EU enlargement's effect on resources available for defense spending depends on how enlargement affects economic growth and on the budgetary costs of meeting enlargement criteria. Both of these impacts are likely to be greater for countries joining the EU than for current members. While applicants expect membership to improve their economies over the long run, meeting EU requirements is likely to be costly in some areas, although the magnitude of costs depends on timetables and specific requirements that have not been established. Current EU members plan to provide financial support for enlargement primarily through the EU common budget. The EU financial framework for 2000-2006 limits assistance to applicant countries to 11 percent of total spending over the period, which is slightly above 0.1 percent of total EU gross national product (GNP).[17] Most of these funds will not be available until countries actually join the EU, which is likely to be several more years.

EU Membership Should Benefit New Members' Economic Growth

EU applicants, whose average per capita GDP in 1997 was about 32 percent of that of current members, expect to derive broad economic benefits from membership. Benefits are expected to flow from several factors: expanded trade due to reduced trade barriers between entrants and current members, increased foreign investment due to lower risks and reduced barriers, and overall institutional reforms associated with joining the EU. Although the requirements of EU membership often coincide with steps toward general economic development in applicant countries, the prospect of membership adds an important motivation for countries to carry out needed reforms. In addition, because the accession process itself increases investor confidence, some of the economic benefits should accrue before formal membership. Finally, applicant countries expect to benefit through financial assistance from the EU although, as we discuss later, the EU's current budget limits the commitment to assistance for applicant countries and new members.

Enlargement Requires Reforms by Applicant Countries

The EU requires that new members have

- stable government institutions guaranteeing democracy, rule of law, and human rights;
- a "functioning market economy" that can withstand competitive pressure and market forces within the EU; and

[17]GNP differs from GDP—the total market value of all the final goods and services produced within an economy in a given year—in that it includes earnings abroad by a country's firms and residents and excludes income earned in that country by foreign firms and residents.

- the ability to take on EU membership obligations, including the adoption, implementation, and enforcement of the EU's entire body of laws, known as the "acquis communautaire."

Some of these criteria are quite general and open to interpretation. For example, having a functioning market economy can be demonstrated through showing sustained economic growth with growing private sector participation. This in turn requires changes across the spectrum of economic institutions. For example, countries' legal systems need to include the regulation of property rights so contracts can be enforced.

Adopting and implementing the full spectrum of EU law, however, requires a number of specific actions. Adopting the acquis is a massive undertaking for accession countries. The acquis comprises 80,000 pages of requirements, which the European Commission has divided into 31 categories, or chapters, for the purpose of carrying out negotiations with applicants. (See app. III for a complete listing of these chapters.) Some requirements of adopting the aquis can be met with simple, technical changes, while others will require large investments. Meeting EU standards for the environment and for infrastructure are most likely to constitute the greatest challenges and costs for the three accession countries we visited.

Enlargement Not Likely for Several Years

The first accessions to the EU from the current enlargement process are not likely to take place for several years, most likely not until 2004-06, according to U.S. and foreign officials with whom we met. Applicant countries' own official timetables remain somewhat shorter—2002 or 2003—as does the timetable officially assumed in the recently adopted EU budget. Enlargement cannot occur until (1) applicant countries make sufficient progress in satisfying EU membership criteria and (2) the EU agrees to reforms in its decision-making processes and possibly changes in its budget.

The timing of accession is ultimately a political decision on the part of current EU members. According to several EU and government officials, while current members have made a political commitment to the idea of enlargement, they have not made a political commitment to the timing or conditions under which it will take place. The degree of support for EU enlargement among current member populations is mixed. According to a 1998 survey conducted on behalf of the EU, 42 percent of respondents favored enlargement, with support ranging from a high of 63 percent in Sweden to a low of 28 percent in Belgium.

In its report on applicants' progress in meeting EU membership criteria, issued in late 1998, the European Commission indicated that while candidates were "broadly on track," countries still had a long way to go in meeting membership criteria. According to the Commission, among the Czech Republic, Hungary, and Poland, Hungary has made the most progress and the Czech Republic the least. The Commission reports that all the candidate countries lack the administrative and judicial capacity to implement the acquis. According to Commission officials, it is not realistic to expect that all the requirements of the acquis will be met prior to negotiation. The accession process does provide for transition periods—periods after membership during which some requirements can be implemented. Views on how extensively transition periods will be granted varied among the officials with whom we talked. Transition periods are generally expected in some cases, however, particularly in the area of meeting environmental standards.

The need to make politically difficult changes in EU policies could impede EU enlargement, according to officials from the EU as well as member and applicant countries. These include several issues with respect to EU decision-making structures and procedures in the Council and Commission, and potentially the EU budget—including the allocation of funds to support agriculture.

EU and member-country officials stated that reforms of the EU decision-making process are necessary prior to enlargement. These reforms include reducing the number of members of the Commission to one per country to accommodate an increasing number of countries (the largest countries now have two members); reweighting the voting power of members in the Council to offset the loss of commissioners; and increasing the use of majority voting in the Council to replace the current system of consensus decision-making. A State Department official characterized the prospect for agreement on these reforms in the near-term as "dim."

The EU financial framework for 2000-2006 (discussed later) reflects most of the reforms that the Commission had determined would be necessary for an expanded EU except with respect to agriculture policy, the area of greatest contention.[18] This has led to the views of some officials that elements of the budgetary framework will have to be revisited prior to

[18]The European Commission laid out in a 1997 document, Agenda 2000, specific changes to EU policies needed before enlargement.

enlargement. In presenting the financial framework, the Council acknowledged that further changes in agriculture assistance payments to current members may be necessary. However, EU countries receiving the largest amounts of agricultural subsidies could potentially use their votes on enlargement to maintain their net level of assistance from the EU at the expense of new members.[19]

Future Budgetary Impacts Depend on Specific Enlargement Terms

The budgetary implications of EU membership for applicant countries depend on the outcome of ongoing membership negotiations with the EU. At this point, total cost estimates have not been developed. While there is general agreement that meeting EU membership requirements will entail significant expenditures by applicant countries, quantifying these costs remains difficult. For example, neither the EU nor the World Bank, which have both worked with applicants to develop accession strategies, has developed broad estimates of accession costs.

EU requirements with respect to environmental standards and transportation infrastructure are expected to be among the costliest for applicant countries to meet. The most comprehensive sector-specific estimates are for environmental reforms, where the World Bank has recently completed analyses of what Poland, Hungary, and the Czech Republic must do to meet EU environmental standards. The World Bank has estimated that Poland's public sector costs of meeting EU requirements could be $5 billion to $11 billion dollars per year for 20 years to cover investment, operation, and maintenance.[20] This represents about 3.4 percent to 7.5 percent of Poland's 1998 GDP and 1.7 percent to 3.7 percent of Poland's projected GDP in 2015. The World Bank estimates Hungary's annual costs of environmental reforms as ranging from 2.1 percent to 5.5 percent of 1997 GDP, and annual costs for the Czech Republic ranging from 2.5 percent to 3.7 percent of 1997 GDP. The difference between the high and low ends of the cost ranges are due to different assumptions about what the specific requirements will be and the details of the compliance plan these countries and the EU agree to.

[19]Currently, about half of all EU appropriations are for agricultural price supports and direct payments to farmers. Between 1993 and 1997, France was the leading recipient of EU agricultural support payments, followed by Germany, Spain, and Italy. Extending these payments to new entrants, whose economies are, on average, about four times as reliant on agriculture as current members, would increase expenditures considerably.

[20]These calculations assume investments are spread over their expected life and discounted to reflect the time value of money. They also exclude what private industry must spend to meet EU standards.

The World Bank’s studies do not determine what portion of estimated costs will be borne directly by national governments. The national budgetary impact of these and other requirements depends on a number of factors, including the degree to which costs are passed on to consumers—through higher utility bills, for example--and the types of financing available. According to these studies, much of the costs would be affordable to households under the low-cost scenario but not under the high-cost scenario. Moreover, since these studies focus only on the costs of meeting enlargement criteria in these areas, they do not attempt to present net assessments of the criteria’s economic costs and benefits.

The World Bank emphasizes that these countries will make many of the required improvements whether they join the EU or not. A common theme we heard from officials in accession countries is that there is substantial overlap between their national development goals and EU requirements in areas such as the environment. However, EU requirements can affect the timing of reforms and thus the relative impact of their costs. For example, Hungarian officials pointed out that, while commercial vehicles in Hungary will eventually satisfy EU emission control requirements, membership criteria will force these requirements to be met by a certain date. This will compress the period of time over which adjustments take place, thus increasing annual expenses.

New EU Financial Framework Limits Expenditures of Current EU Members for Enlargement

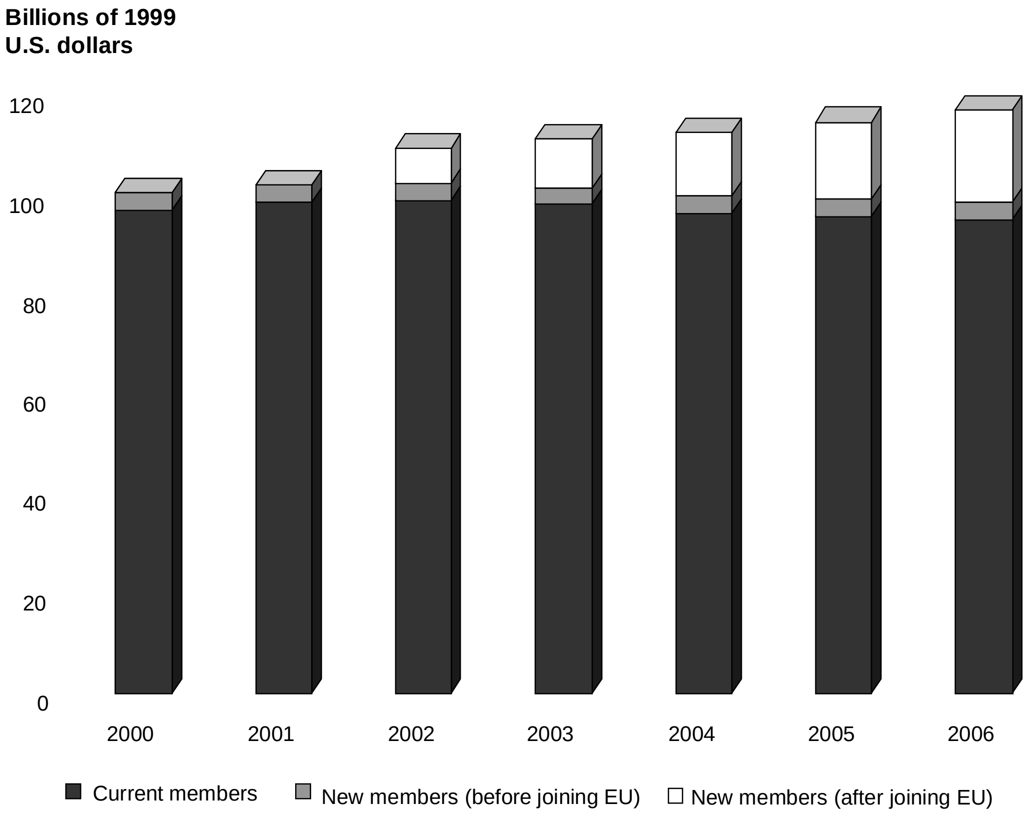
EU members plan to support enlargement of the Union primarily through the EU budget, not their national budgets. According to the financial framework adopted in March 1999, the EU will appropriate about 11 percent of its spending during 2000-2006, about $80 billion dollars, to applicant and new member countries. This is slightly above 0.1 percent of current member GNP.[21]

As illustrated in figure 7, the financial framework reflects some increase in total spending, since members’ GNP is assumed to grow over the period, and revenues are limited to a percentage of GNP. The framework shows only a slight decrease in agriculture and regional development payments to current members. It assumes some new members would join in 2002, and then receive a portion of agriculture and regional development payments.

[21]Financing for the EU budget comes from GNP-based contributions, value-added taxes, and agricultural levies and customs revenues. Member contributions are limited to a percentage of total EU GNP, which is 1.27 percent in the newly adopted budget.

The framework reflects the decision to set an explicit cap on the amount of funds that new members will receive over the period. According to the EU, there are budgetary walls between the funding for current and new members. Thus, if enlargement takes place after 2002, current EU members would not get the funds earmarked for new members for that year.

Figure 7: Planned EU Spending for Current and Applicant Members, 2000-2006



Source: European Council.

Most of the financial assistance, 68 percent, given to new members will be for regional development. The amount of assistance earmarked for new members is not sufficient to support new members at the same level as current members. EU officials have stated that the EU's greatest contribution to the economic development of applicant countries is not financial assistance, but rather fostering an environment conducive to increased trade and influxes of private capital. However, a State Department official stated that this budgetary framework may have to be modified before enlargement can take place.

Defense Budgets Face Strong and Increasing Pressure From Domestic Spending

Defense budgets face strong and increasing pressures from demands for domestic spending in both West and Central European countries. Pensions, in particular, are placing pressure on national budgets and expenditures will increase dramatically as populations age, unless difficult reforms are made. Health care costs are also expected to rise. In the long run, the pressure from rising entitlement costs may have a greater effect on countries' defense budgets than EMU or EU enlargement. Recent budgetary debates in both West and Central European countries have highlighted the tradeoffs facing decisionmakers as they try to satisfy demands for social spending within a budgetary environment characterized by lower economic growth and fiscal constraints.

Social Spending Is a Large Portion of National Budgets

The countries we reviewed have historically spent a large portion of their GDP and government budgets on social programs such as pensions, health, and welfare. For example, according to OECD figures, in 1995—the latest year for which comparable data are available—France, Germany, Italy, and the United Kingdom spent an average of 26 percent of GDP on social programs, compared with 16 percent in the United States.[22] Public pensions and health programs are the largest component of government spending for social programs in these countries, averaging about 80 percent of the total. Central European governments also devote a significant portion of GDP to social programs. According to IMF data, using a slightly different measure than the OECD, the Czech Republic, Hungary, and Poland spent about 22 percent of GDP in 1997 on social programs (including pensions, welfare, and health).

The cost of public pension programs has been placing increasing pressure on government budgets in some countries. Payroll taxes in several countries, although considered high, do not cover the annual costs of current pension programs, requiring sometimes large and growing portions

[22]According to OECD figures, about half of total government spending in the United States is for social programs, about the same as in Western Europe. However, government spending in Europe is a larger portion of GDP than in the United States.

of the national budget to fill the gap.[23] For example, in Germany, transfers to pension funds increased from 16 percent to 22 percent of federal government spending between 1994 and 1998.[24] In Italy, government contributions to the state pension system increased from 2.3 percent of GDP in 1997 to 2.7 percent in November 1998. In 1998, the Czech Republic's pension system required payments from the national budget to finance the gap between payroll taxes and pension expenditures equivalent to roughly 1.1 percent of GDP. Officials there told us that without serious change in the current system, these deficits would continue.

However, reforming pension programs can increase costs in the short term. For example, in 1998, Hungary launched an ambitious reform of its pay-as-you-go pension program. Although the move to add mandatory individual savings accounts enhanced the long-term viability of the system, Hungary's short-term budgetary costs will require payment for two parallel pension systems over the next several years, reflecting these transition costs.

The growing pressures for spending for domestic needs such as addressing unemployment and improving education are reflected in the 1999 budget debates for all the countries we studied. Germany, for example, increased spending for education and to reduce youth unemployment while continuing to spend large sums related to the integration of the eastern region. France's budget also increased funding directed at lowering unemployment and improving education, and Italy spent more for social and regional development. In the United Kingdom, half of all planned budgetary increases are in education and health. In Central Europe, Poland is implementing costly pension, health care, industrial, and local government reform programs. The Czech Republic's mildly expansionary budget is geared to spur growth. And Hungary's budget shows increased spending for pensions and education, as the new government attempts to satisfy campaign promises while limiting deficit spending.

[23]Most countries we studied have multiple public pension programs, and the complex funding and benefit details of these programs differ from country to country. Governments collect payroll taxes to support the current year's public pension outlays. This is known as a "pay-as-you-go" funding scheme. General government budgets are used to cover any gaps. Pay-as-you-go schemes are not generally designed to accumulate and set aside funds to pay for future liabilities.

[24]National budget figures cannot be compared across countries, due to significant differences in definitions; spending categories; and distinctions between national, regional, and local government responsibilities.

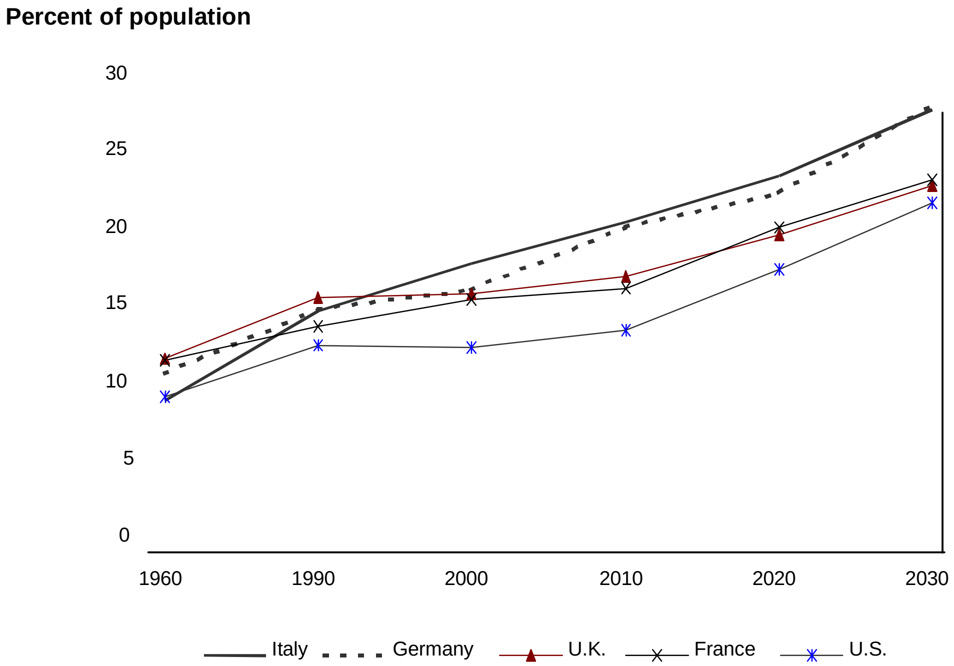
Aging Populations Present Budgetary Challenge

Demographic trends present a huge budgetary challenge for the countries we studied, although the budgetary consequences for the United Kingdom are much less negative than those for the other countries.[25] According to studies by the OECD, the World Bank, and national governments, in the absence of substantive public pension reform efforts, budgetary stability will come under significant strain in the next century. German Central bank officials, for example, described the projected fiscal consequences of Germany's demographic problems as catastrophic.

The share of retired elderly (people over 65) in most developed countries, which grew slowly over the last 25 years, will begin to rise dramatically after 2010 as the baby boom generation moves into retirement and other demographic forces play out. These changes will generally be greater in European countries than in the United States, as shown in figure 8.

[25]The U.K.'s population is aging less rapidly and its pension system is less generous than in France, Germany, and Italy. The United Kingdom has also undertaken a series of reforms, including partial privatization of its pension system, reducing the fiscal burden on the national government.

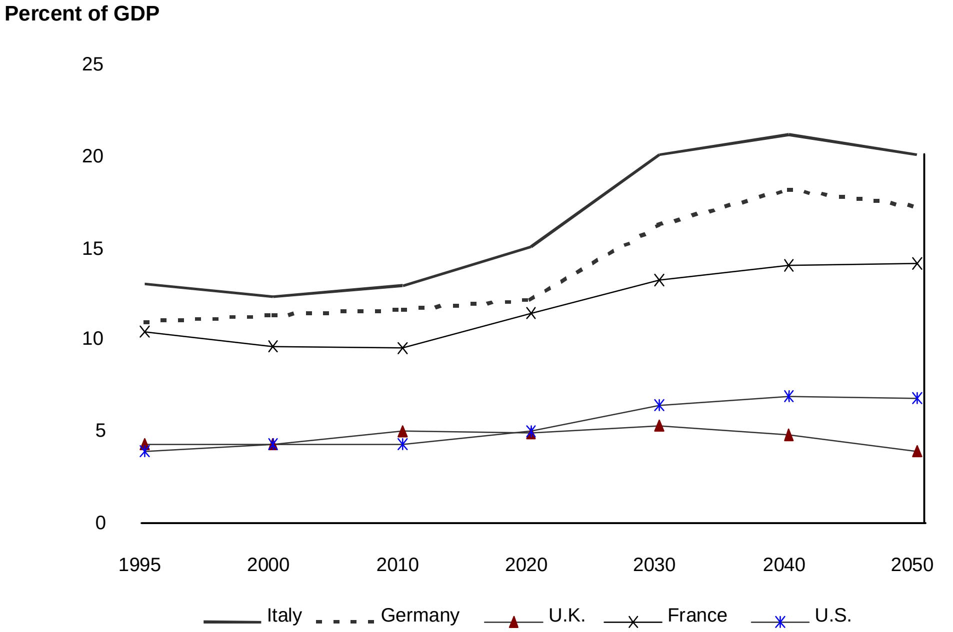
Figure 8: Share of Population Over 65 in Four West European Countries and the United States, 1960-2030



Source: OECD.

The projected impact on public pension expenditures of these demographic trends for France, Germany, Italy, the United Kingdom, and the United States is shown in figure 9.

Figure 9: Pension Expenditures as Percent of GDP in Four West European Countries and the United States, 1995-2050



Source: OECD.

Figure 9 shows that, using projections based on current trends and policies, public pension costs in France, Germany, and Italy will consume growing proportions of total GDP. Predicted costs for the United Kingdom are lower in part due to reforms that have included lower benefits. By several measures, based on current policies, the future budgetary consequences of the trends in France, Germany, and Italy are very serious. For example, the OECD has estimated that current pension policies will drive the national debts of Germany and Italy over 200 percent of GDP by 2030. To maintain their respective national debts at current levels, the OECD estimates that Italy and Germany will need to maintain unrealistically high budget surpluses of 7 percent of GDP or greater per year by 2030.[26]

[26]A 1997 OECD study estimated the net present value of long-term financing shortfalls of government pension programs for a number of countries. Expressed as a percent of a country's 1994 GDP, estimated shortfalls were 24 percent for the United Kingdom, 60 percent for Italy, 62 percent for Germany, and 102 percent for France.

Central European governments face similar budgetary problems due to demographic trends. Polish officials have projected they will reach unsustainable levels of spending in 10 to 15 years. Likewise, Czech officials reported being in the same situation. Long-term projections for Hungary are somewhat more optimistic, given recent reforms, although long-term funding shortfalls are still projected.

Aging populations are also expected to increase health care costs in these countries, although less dramatically. Public spending on health, which throughout the 1980s equaled approximately 6 percent of GDP in the EU countries we studied, began to rise early in the 1990s. According to one study, this spending is projected to increase to approximately 9.5 percent of GDP in 2050, under current trends and policies. Expenditures on health care for the elderly account for nearly all of this projected increase. According to the OECD, such estimates are highly dependent on the future cost of medical technology and the outcome of reforms aimed at improving efficiency.

Although the dramatic budgetary consequences of aging populations appear to be a number of years away, significant political and budgetary impacts will be felt sooner, according to a number of officials and analysts. The longer pension system reforms are delayed, for example, the more stringent they will have to be. Officials told us that achieving the political consensus to carry out reforms to temper the budgetary consequences of aging populations will be difficult. They also told us that the hardest and potentially most effective choices, such as raising the retirement age or reducing benefits, are not yet being seriously addressed. The political challenges are compounded by the fact that some long-term reforms can have negative budgetary consequences in the short to medium term.

Conclusions

While neither EMU nor EU enlargement affect defense spending decisions directly, they can affect the flexibility of governments to allocate resources to various needs. The impacts of EMU and EU enlargement on overall government budgets remain difficult to predict. The estimated costs of meeting some EU membership requirements are quite high. But just how high these costs will be, who will pay them, and over what period of time they will be incurred remain to be determined. Clearly, however, EU membership is a priority of many Central European countries, and support for it could fare well as budgetary decisions are made. Over the next several years, EMU requires additional cuts in deficits in participating countries. While these cuts are not large relative to the deficit reductions already made, they are not easily achieved, particularly in countries that are experiencing slow growth. Since defense is a relatively small portion of the budget, it can arguably be protected from cuts. However, if the political support for defense spending is low, it may be a more attractive target than other spending. Pressures for increased spending on pensions and also health care due to aging populations will strain future budgets in many European countries. Strong economic growth is clearly a key to governments having any flexibility for meeting competing needs for resources.

Agency Comments and Our Evaluation

The Defense Department provided written comments on a draft of this report and concurred with our findings (see app.V). The Department of State provided oral comments on a draft of this report and concurred with our findings. DOD and the Department of State also provided technical comments, which we incorporated where appropriate. In oral comments on a draft of this report, the Department of the Treasury, the European Union, the World Bank, and NATO provided technical comments, which we incorporated where appropriate.

As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 15 days from its issuance date. At that time, we will provide copies of this report to other appropriate congressional Committees; the Honorable William Cohen, the Secretary of Defense; the Honorable Madeleine Albright, the Secretary of State; and the Honorable Lawrence Summers, the Secretary of the Treasury. We will also make copies available to others upon request.

If you or your staff have any questions about this report, please contact me at (202) 512-4128. Other GAO contacts and staff acknowledgments are listed in appendix VI.

Benjamin F. Nelson

Benjamin F. Nelson, Director
International Relations and Trade Issues

Contents

Abbreviations

DOD	Department of Defense
EMU	Economic and Monetary Union
ECB	European Central Bank
EU	European Union
GDP	gross domestic product
GNP	gross national product
IMF	International Monetary Fund
NATO	North Atlantic Treaty Organization
OECD	Organization for Economic Cooperation and Development

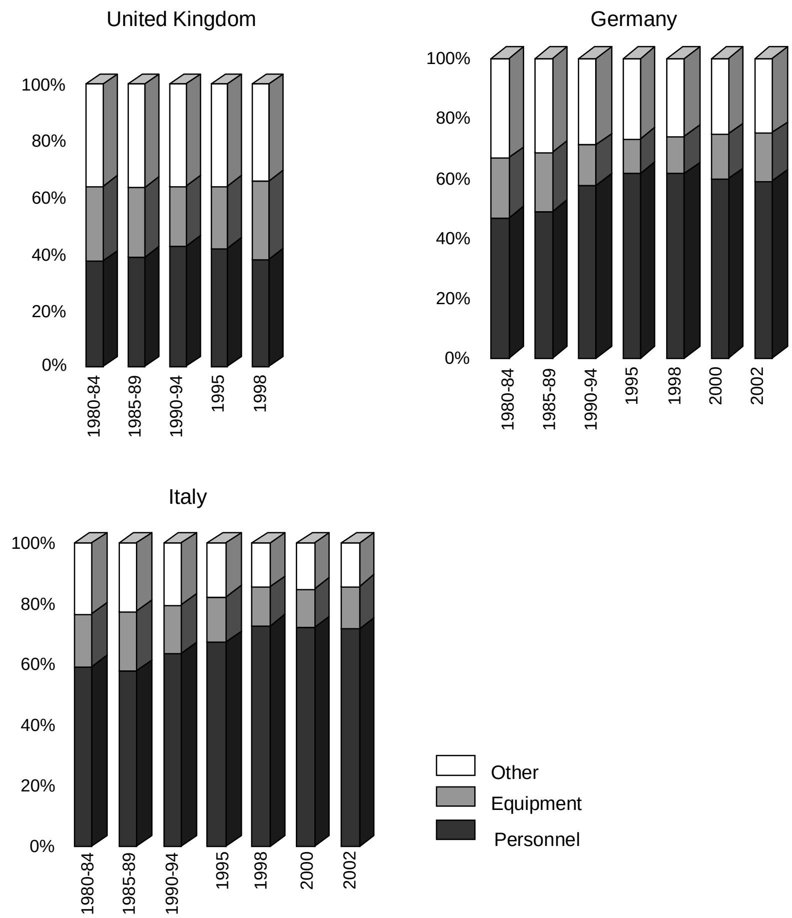
Composition of Defense Spending in Selected European Countries

The defense budget challenges of the West and Central European countries we studied arise in part from large personnel costs, large procurement projects, and deployments. Officials have identified the need to prioritize defense requirements as key to effectively addressing new security challenges.

Western Europe

Personnel expenses for the countries we studied in Western Europe generally constitute a large portion of their defense budgets—60 to 70 percent in some cases—and have affected the ability of these countries to appropriate additional funding for defense modernization. In Germany and Italy, in particular, personnel expenses, as a share of overall expenses, have been rising in the Cold War and post-Cold War periods, as shown in figure I.1. While these countries expect personnel expenses to fall in the future, this may be complicated by sensitive political and social issues associated with the elimination of conscription and the reduction in personnel strength. In the United Kingdom, with its all-volunteer force, personnel expenses have decreased relative to other expenses since the end of the Cold War.

Figure I.1: Trends in Composition of Defense Spending in Three West European Countries, 1980-2002, 2003



Note 1: Comparable data for France are not available. Breakout of future defense spending for the United Kingdom is not available.

Note 2: "Other" primarily includes spending for operations, maintenance, and infrastructure.

Sources: GAO analysis of data from North Atlantic Treaty Organization (NATO) and national ministries of Defense.

Conscription

Compulsory military service, known as conscription, has been a fundamental element of defense planning for France, Germany, and Italy since the end of World War II. It has both integrated the professional core of the military into society and, in some cases, provided a source of employment for youth. While conscription may have been effective during the Cold War for staffing large territorial armies, the restrictions attached to it pose problems for post-Cold War security conflicts, according to officials with whom we met. For example, conscripts in Italy cannot be deployed to an overseas conflict or crisis except on a volunteer basis. When they do volunteer, it can be a costly deployment for the country because Italy's laws require that the volunteers be paid at a higher rate when on an overseas deployment.

France, Germany, and Italy acknowledge the lack of flexibility inherent in conscription, as well as the expense of maintaining large numbers of these forces, and are in various stages of making or considering changes. A shift to a professional, volunteer force can initially result in higher personnel costs, although costs can be lower over time as the size of the force is decreased, according to U.S. and foreign officials. In addition, ending conscription can exacerbate countries' unemployment and associated problems, according to military personnel specialists. In 1996, the French government presented a plan for downsizing and professionalizing the French military, including a massive reduction of conscripts within the French armed forces, to be accomplished by 2002. Italy has also begun to professionalize its military forces but is proceeding at a slower pace than France. The Italian government believes a gradual transition is necessary because Italy has never had a professional military, and also because conscription forces have provided volunteer labor that is relied on by both the military and the outside community. As a result of this gradual transition, however, personnel costs, as a percent of total defense spending, increased from 67 percent to nearly 73 percent between 1995 and 1998 to accommodate professionalization and maintain conscription. In May 1999, Germany launched the first comprehensive study of the structure of its armed forces in almost 30 years. This review, which will look out to the 2010 time frame, will include an examination of conscription policies.

Procurement of Large Systems

The expense of developing and procuring large military systems significantly limits flexibility in defense budgets in many European countries, according to U.S. and European officials. While participation in such projects can serve national interests, through increasing employment, enhancing technology, and boosting international prestige, it can also limit the ability of countries to buy other needed systems and equipment for modernization programs. The prime example of this is the EF-2000 "Eurofighter." Of the countries we reviewed, three are participating in this project--Germany, Italy, and the United Kingdom. Our analysis shows that

Eurofighter procurement is accounting for a growing portion of the procurement budgets in each of these three countries. Germany, for example, is procuring 180 Eurofighters, which represents approximately 28 percent of the costs of its major combat equipment purchases in 1999. This is an increase from 24 percent in 1998. According to U.S. embassy officials in Bonn, Eurofighter procurement, in combination with current overseas deployments, has had a depressing effect on the funding available for other defense programs. They stated that many German defense procurement programs have been delayed or are awaiting a decision whether or not to go forward, as a result of funding uncertainty.

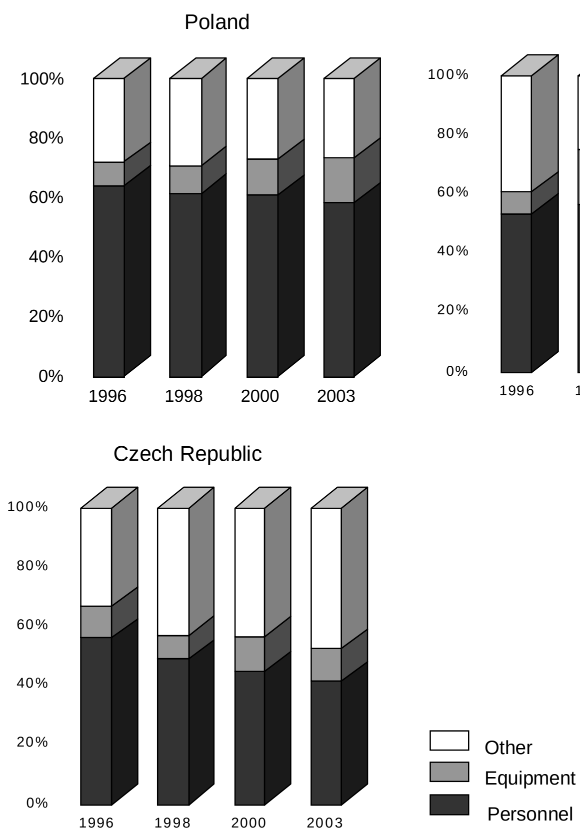
The Eurofighter is also important to the Italian government because it supports Italian industry and jobs and provides international prestige. To fund such a large program, the Italian government is relying in part on financing sources outside the defense budget, such as the Ministry of Trade and Industry. Because of this funding arrangement, assessing the Eurofighter's impact on other defense programs is difficult. However, military analysts both inside and outside of Italy have expressed concerns regarding Italy's ability to fund the Eurofighter as well as other needed systems and equipment, particularly given costly military deployments such as Kosovo and expenses involved in moving to a professional military force.

The United Kingdom is procuring 232 Eurofighter aircraft--the largest number among participating countries. U.S. embassy officials in London stated that expensive procurement programs such as the Eurofighter must necessarily affect other programs, particularly when the defense budget is not growing. Moreover, recent U.K. government reports indicate high cost overruns from large weapon system purchases, with the Eurofighter accounting for nearly half of the total cost overruns.

Central Europe

Personnel costs also constitute a large portion of the defense budgets for Poland, Hungary, and the Czech Republic—between 49 and 61 percent in 1998. Operational and personnel costs combined equal nearly 80 to 90 percent of the defense budgets, leaving 10 percent or less for major equipment. According to U.S. embassy and European government officials, a major challenge for these nations has been reducing the large, top-heavy, military personnel structures—a holdover from their membership in the Warsaw Pact. Conscription is a political and economic issue for these Central European countries, as it is in the West, and affects these countries' ability to reduce their military force numbers. Projections indicate that personnel expenses, as a share of overall expenses, will decline slightly in the next 5 years but will still remain a large percent of the overall defense budget (figure I.2 shows the composition of defense spending in the Czech Republic, Hungary, and Poland).

Figure I.2: Trends in Composition of Defense Spending in Three Central European Countries, 1996-2003



Note: "Other" primarily includes spending for operations, maintenance, and infrastructure.

Sources: GAO analysis of data from NATO and national ministries of Defense.

Achieving defense reform and modernization goals depends on the ability of these countries to balance competing elements of defense spending. Undertaking certain high-cost modernization programs could prevent these Central European nations from meeting their NATO force goal commitments if the purchases are not carefully planned and budgeted, according to U.S. Department of Defense (DOD) officials. In recognition of its budgetary limitations, Hungary has deferred purchase of new fighter aircraft until after 2001 and will continue to use MIG-Soviet-built aircraft. The Czech Republic has also deferred purchasing new fighter aircraft but is proceeding with the procurement of subsonic multirole jets (the Aero Vodochody L-159). Poland has decided to move ahead now with new multirole fighter aircraft but has not decided whether to lease or buy the new systems. U.S. government officials stated that these aircraft purchases are feasible for Poland if the country meets GDP-growth projections of at least 4.2 percent and spends defense budget increases` primarily on procurement.

Funding Requirements of Peace Support Operations

In our discussions with U.S. and foreign government officials, nearly all of them identified the increasing number of out of country deployments, particularly in the Balkans, as a growing drain on their defense resources. Combined with large aircraft purchases and high personnel costs, these operations are affecting the ability of the NATO countries we studied to carry out restructuring and modernization, according to these officials. The expense of the current operation in Kosovo is requiring some European countries to draw on other government funds or, in the case of Germany, appropriate supplemental funds for defense. Defense officials from France and the United Kingdom told us that requests for additional funding from their treasuries may be made later this year. Funding the Kosovo operation has been particularly difficult for the new NATO members because of their ongoing defense and economic reforms, according to U.S. government officials. The Czech Republic, for example, plans to increase its budget deficit in order to fund humanitarian aid. In Poland, contributions are being funded from budget “reserves,” as a spending contingency fund was quickly exhausted. According to U.S. embassy officials, the Polish Defense Minister has frequently complained to the press that the overall budget reserve for emergencies will also be quickly depleted.

Possible Effects of European Economic and Monetary Union on National Economic Growth

European Economic and Monetary Union (EMU), particularly the adoption of a common currency, can affect economic growth in participating countries through several mechanisms. Overall growth effects depend both on how these mechanisms individually affect growth, and on how they interact. Both are subject to considerable uncertainty. Table II.1 summarizes the ways EMU could benefit economic growth. Table II.2 summarizes the ways EMU could harm economic growth.

Table II.1: Ways in Which EMU Could Benefit Economic Growth

- Governments will be forced to undertake structural reforms, especially in improving the flexibility of labor markets. This will allow economies to adjust more easily to economic downturns, and therefore benefit long-term growth.
- Maintaining low budget deficits, which EMU requires, helps establish the foundations for stronger economic growth by limiting the government sector's absorption of national savings.
- Exchange rate variability among euro area countries is eliminated. Consumers and businesses will no longer incur currency conversion costs, and the macro economy will be spared the impacts of large fluctuations in currency values that harmed European economies in the early 1990s.
- The European Central Bank is required to keep prices stable, which should contribute to lower interest rates.
- A common currency allows consumers to easily compare prices across borders, spurring economic competition and eventually boosting efficiency and productivity.

Table II.2: Ways in Which EMU Could Hurt Economic Growth

- Common economic policies, particularly monetary policies, may not be well-suited to the needs of various countries that are at different stages of the business cycle. For example, a single interest rate set by the European Central Bank for 11 different economies could possibly lead to stagnation in some countries and overheating in others.
- National leaders will no longer be able to use monetary or exchange rate policy to cope with economic downturns. Without these tools, some countries may suffer additional pain from economic shocks that do relatively little harm to the rest of the euro area.
- The limitations on government spending will constrain national efforts to increase social spending during times of recession.
- Countries may be unwilling to continue to comply with EMU's requirements or adopt politically difficult structural reforms, especially in the labor market. A series of national decisions at cross-purposes could place tremendous strain on the ability of EMU to hold together politically.

Topics of Negotiation for EU Accession

Table III.1 presents the 31 chapters of the acquis communautaire, or the European Union's body of laws, for the EU's negotiations with EU applicant countries regarding those countries' adoption of the acquis. Also shown are examples of topics included in each chapter.

Chapter	Examples
1. Free movement of goods	Export procedures; elimination of trade barriers.
2. Freedom of movement of people	Right of residence for employees, self-employed persons, and students.
3. Freedom to provide services	Service activities including insurance, banking, and stock exchanges.
4. Free movement of capital	Relations between financial institutions and consumers.
5. Company law	Formation, mergers, and division of public limited liability companies.
6. Competition policy	Competition principles; intra-EU dumping practices: and national trading monopolies.
7. Agriculture	Processing and marketing of agricultural products; agricultural research; and setting of compensatory amounts.
8. Fisheries	Catch quotas and management of stock; agreements with nonmember countries.
9. Transport policy	Ground transport safety conditions; shipping vessel registration; and air route distribution.
10. Taxation	Income and corporate taxes; excise duties; and prevention of tax evasion and tax avoidance.
11. Economic and monetary union	Limitations on government deficits; harmonized indexes of consumer prices; and provisions for the introduction of the euro.
12. Statistics	Collection of statistical information on tourism; statistics on distribution of earnings.
13. Social policy and employment	Working conditions; wages; and employment incentives.
14. Energy	Coal rates; nuclear energy safeguards; and oil and gas supplies and stocks.
15. Industrial policy	Research and technological development; competitive pricing and other sale conditions.
16. Small- and medium-sized enterprises	Interest subsidies for loans; taxation; and technological innovation.
17. Science and research	General principles and research sectors.
18. Education and training	Mutual recognition of diplomas, certificates, and other evidence of formal qualifications.
19. Telecommunications and information technologies	Policy on data processing; directive on competition in the markets for telecommunications services.
20. Culture and audiovisual policy	Resolution on electronic publishing and libraries.
21. Regional policy and coordination of structural instruments	Monitoring and coordination of regional state aid; aid for stricken regions; and community loans.
22. Environment	Nuclear safety and radioactive waste; water protection and management; monitoring of atmospheric pollution; prevention of noise pollution; and chemicals, industrial risk, and biotechnology.
23. Consumers and health protection	Consumer information; protection of economic interests; and protection of animals.
24. Cooperation in the fields of justice and home affairs	EU extradition procedures; cooperation to combat international organized crime.
25. Customs union	Tariff types, quotas, and ceilings.

(continued)

Chapter	Examples
26. External relations	European political cooperation; multilateral relations; and commercial policy.
27. Common foreign and security policy	Regulation on the reduction of economic relations with the Federal Republic of Yugoslavia.
28. Financial control	Decision conferring powers to carry out measures of control regarding EU revenue and expenditure.
29. Financial and budgetary provisions	Impact on the EU budget of the accession. Arrangements for the collection of own resources.
30. Institutions	Principles, objectives, and tasks of treaties.
31. Other[a]	None identified as of June 1, 1999.

[a]The EU set aside chapter 31 to cover any major issues that arise during negotiations that were not covered in the preceding chapters.

Source: European Commission.

Objectives, Scope, and Methodology

The Chairman and the Ranking Minority Member of the Subcommittee on Defense, Senate Committee on Appropriations, asked us to assess how the implementation of European EMU and the enlargement of the EU may affect our European allies' ability to sustain or increase their defense budgets. To address this issue, we collected and analyzed information on (1) projected defense spending for several European countries, (2) budgetary effects of EMU implementation and EU enlargement, and (3) other significant factors that may affect countries' ability to share in the costs of NATO over the long run.

Our work focused on seven European countries: the four members of NATO with the largest defense budgets in Europe (Germany, France, Italy, and the United Kingdom) and the three newest members of NATO (Poland, Hungary, and the Czech Republic). We chose these countries because (1) collectively they accounted for over 75 percent of the total gross domestic product (GDP) and defense spending by all European NATO members and (2) because they included all three newest members of NATO. We visited all of these countries except France, which is not part of NATO's integrated military command. We also contacted officials at DOD, State, and Treasury. We also obtained access to the World Bank and International Monetary Fund (IMF) officials and analytical studies through the staffs of the U.S. members of their Boards of Executive Directors. The European governments in our study provided us access to reports and staff from a variety of ministries.

To determine levels and composition of defense spending in Europe, we interviewed and obtained data from officials in the U.S. government, NATO, EU applicant countries, current EU member countries, and academic and private sector institutions. During our visits to NATO countries, we discussed planned defense spending trends with officials from the ministries of defense, finance, and treasury; parliaments; national audit offices; U.S. embassies; and defense research institutes such as the International Institute for Strategic Studies in London, the Center for the Study of International Politics in Rome, and the Government Center for Strategic Studies in Warsaw. We also collected defense budget data and interviewed officials from the Central Intelligence Agency, the Defense Intelligence Agency, the National Defense University, and the Council on Foreign Relations. To determine past and present defense spending trends (1980-98) for the figures used in the report, we relied exclusively on NATO data and its definition of "defense expenditure." NATO defense budget forecasts for NATO member countries are classified. To present unclassified information on future defense spending levels, we obtained defense budget projections from the host countries, calculated yearly growth rates, and applied these growth rates to NATO's 1998 spending level for each country. Similarly, for the composition of defense budgets and the breakout of these budgets into "personnel," "equipment," and "other," we relied on NATO data for 1980-98. For future trends, we relied on budget projections from the countries. We applied growth rates for each of these categories, derived from the countries' budgets, to NATO's 1998 breakouts. We discussed our methodology with DOD officials, and they concurred with the logic of our approach.

To assess the consequences of EMU on defense spending, we collected and analyzed information on EMU's effects on national budgets and economic growth from the U.S. Department of the Treasury, the Department of State, and the Department of Defense; the EU; the European Central Bank; EMU member countries; the World Bank; the IMF; and academic and private sector organizations. We met with officials from Germany and Italy to discuss how meeting EMU membership criteria has affected their national budgets. Within these countries, we obtained information and met with officials from the Central banks, the finance ministries, U.S. embassy staff, and academic institutions.

To examine the consequences of prospective EU enlargement on defense spending, we assessed how enlargement could affect national budgets and economic growth. We collected and analyzed information and interviewed officials from the U.S. government, the EU, applicant governments, current EU member governments, multilateral institutions, and academic institutions. We discussed the objectives and total costs of EU enlargement with officials at the Department of State, the World Bank, and the EU's Council, Commission, and Parliament. To identify the potential impact of meeting EU membership criteria on the respective national budgets of current and applicant members, we interviewed officials and obtained information from ministries of finance and foreign affairs. In the applicant countries, we also met with officials from the national parliaments, EU integration offices, U.S. embassies, and local academic institutions.

To identify primary nondefense domestic budgetary trends and pressures, we met with officials from the U.S. government, current EU member countries, applicant member countries, multilateral organizations, and academic and private sector organizations. We obtained data and analytical studies and interviewed officials from the Organization for Economic Cooperation and Development, the World Bank, the IMF, and economic institutes, including PlanEcon. In the countries we visited, we discussed the major areas of the domestic budget with officials from the Central banks and the ministries of finance, industry and trade, and labor and social affairs; U.S. embassies; and local academic institutions.

The information in this report concerning foreign laws and regulations does not reflect our independent legal analysis, but is based on interviews and secondary sources.

We performed our review from April 1998 to June 1999 in accordance with generally accepted government auditing standards.

Comments From the Department of Defense

OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE

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INTERNATIONAL SECURITY AFFAIRS

28 June 1999

Mr. Benjamin F. Nelson
Director, International Relations
and Trade Issues
National Security and International
Affairs Division
U. S. General Accounting Office
Washington, D. C. 20548

Dear Mr. Nelson:

This is the Department of Defense response to the General Accounting Office (GAO) draft report, *NATO: Implications of European Integration for Allies' Defense Spending*, dated 10 June 1999 (GAO Code 711325), OSD Case 1841.

The Department concurs with the draft report. Our final suggested technical changes for clarification and accuracy are provided as a separate attachment to this letter.

The Department appreciates the opportunity to comment on the draft report.

Sincerely,

James Q. Roberts
Director, NATO Policy

Attachment: a/s

GAO Contacts and Staff Acknowledgements

GAO Contacts

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Acknowledgements

In addition to those named above, Dave Maurer, Elizabeth Guran, Arturo Holguin, Christian Hougen, Bruce Kutnick, and Jane Li made significant contributions to this report.

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