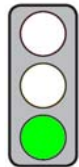


KEY ISSUES

Objective of the Communication: The Commission sets out common principles for the national shaping of the Fiscal Compact's correction mechanism with which 25 of 27 EU states wish to consolidate their budgets.

Parties affected: All citizens and politicians.



Pros: (1) The option provided by the Fiscal Compact to set the correction mechanism below constitutional level and thus to relativise it is impeded by the Commission's specification that it should not be possible to change the mechanism by means of ordinary budgetary laws.

(2) The suggestion that the correction measures should focus on expenditure cuts or increased revenues is appropriate, since unlike measures to increase potential growth, these have a direct impact.

Cons: Although the developed principles and the requests addressed to the Contracting Parties are all appropriate to the problem, it is unclear to what extent they are legally binding.

CONTENT

Title

Communication COM(2012) 342 of 20 June 2012: **Common principles on national fiscal correction mechanisms**

Brief Summary

► Context and objectives

- The Fiscal Compact of 2 March 2012 obliges 25 of the 27 EU states (excluding Great Britain and the Czech Republic) to introduce a debt brake (Art. 3–8 of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union; referred to as “Fiscal Compact” below; see [CEP Policy Brief](#)).
- The debt brake consists of two components (Art. 3 Fiscal Compact):
 - Component 1: Specification of the permitted annual structural deficit [“medium-term budgetary objective” (MTO)]
 - The structural deficit is the public deficit cleared of cyclical effects and one-off measures.
 - The MTO is a specification of the permissible amount of the structural deficit. This requirement is based on the Stability and Growth Pact (SGP) [Art. 2a Regulation (EC) No. 1466/97]. In order to not exceed the MTO, the structural deficit may equal:
 - in principle a maximum of 0.5% of the gross domestic product (GDP);
 - where public debt is “significantly” below 60% of GDP, the structural deficit may reach at most 1% of GDP.
 - Component 2: “correction mechanism”
 - Contracting Parties which deviate “significantly” from their MTO or the adjustment path leading to it must take correction measures (Art. 3 (2) Fiscal Compact).
 - A “significant” deviation means that a MTO or the adjustment path has been missed by 0.5 percentage points of the GDP in one year or by at least 0.25 percentage points in two successive years [Art. 6 (3) Regulation (EC) No. 1466/97].
- In the Fiscal Compact the Commission is called upon to substantiate its general requirements regarding correction mechanisms. The present Communication is the Commission's response to this request. It proposes seven principles which the Contracting Parties should take into account when shaping the correction mechanism at national level.

► Principle 1: Legal status of the correction mechanism

- According to the Fiscal Compact, the provisions of the correction mechanism must
 - “preferably” be constitutional but definitely of “binding force and permanent character”, or
 - guarantee in other ways that the correction mechanism – in as far as there is a “significant” deviation – is adhered to throughout the national budgetary procedure.
- Pursuant to the Fiscal Compact, the correction mechanism must safeguard the rights of national parliaments.
- According to the Commission, it should not be possible to change the correction mechanism through ordinary budgetary laws.

► **Principle 2: Consistency of the correction mechanism with the SGP**

- According to the Commission, the correction mechanism must be consistent with the provisions of the SGP in terms of:
 - the MTO and the adjustment path leading there;
 - the “significant” deviation from the MTO and the adjustment path that leads there; and
 - the “exceptional circumstances” allowing for a deviation from the MTO and the adjustment path that leads there. An “exceptional circumstance” [Art. 3 (3) lit. b Fiscal Compact in conjunction with Art. 5 (1) Regulation (EC) No. 1466/97] is when:
 - an event has a major impact on the public purse and is outside the control of the Contracting Party, or
 - a severe economic downturn hits the eurozone or the entire EU.
- According to the Commission, the size and the timeline of the correction for returning to the MTO and/or the adjustment path must be consistent with the recommendations made to the Contracting Party under the SGP framework.

► **Principle 3: Activation of the correction mechanism**

- According to the Fiscal Compact, the correction mechanism is activated in the case of a “significant” deviation of a Contracting Party from its MTO and/or adjustment path.
 - According to the Commission, there is a deviation that activate the correction mechanism if:
 - during the SGP control procedure (Art. 6 (1) Regulation (EC) No. 1466/97 in conjunction with Art. 121 (3) TFEU) the Council identifies a “significant” deviation, or
 - thresholds, which can be defined by the Contracting Party, are either reached or exceeded (“country-specific criteria”). The country-specific criteria can provide for an activation if:
 - a “significant” deviation occurs or
 - there is the threat of a “significant” deviation.
- The country-specific criteria must be based on the SGP’s concept of “significant” deviation.

► **Principle 4: Size and timeline of the correction**

- According to the Commission, the extent to which the structural deficit is to be corrected per year should a “significant” deviation occur must already be laid down by the Contracting Party in the course of setting up the correction mechanism. The larger the “significant” deviation, the larger the size of the corrections. Moreover, the following should apply:
 - Contracting Parties who deviate “significantly” from the adjustment path should nonetheless reach their MTO within the originally prescribed timeline;
 - Contracting Parties who achieved their MTO but then deviated from it “significantly” should return to it as quickly as is realistically possible, which “generally” means either the year immediately following the deviation or the subsequent year at the latest. The deadlines serve as reference scenarios from which Contracting Parties may deviate to a certain degree.
- According to the Commission, in the event of a “significant” deviation, at the beginning of a correction the Contracting Party must adopt a correction measures plan which is binding until either the MTO or the adjustment path has been reached.

► **Principle 5: Possible correction measures**

- According to the Commission, the correction mechanism may prescribe measures which must be taken if the correction mechanism is triggered. This includes cuts in expenditures or increased taxes, provided they contribute to achieving the MTO.
- According to the Fiscal Compact, the general government must comply with the structural deficit threshold. According to the Commission, the correction mechanism may contain requirements as to which sub-sector of the general government should contribute to which part of the correction. The sub-sectors of the general government are the Federal State, “Länder”, municipalities and the social insurances [Recital 23 Directive 2011/85/EU in conjunction with Regulation (EC) No. 2223/96]. Sub-levels of the general government must not jeopardise the general government’s chances of achieving the MTO.

► **Principle 6: Suspension of the correction mechanism**

- According to the Commission, the Contracting Party may suspend the correction mechanism for a limited period if there are exceptional circumstances as defined by the SGP (“escape clause”).
- Upon expiry of the suspension the Contracting Party must:
 - meet the MTO within the timeline prescribed by the SGP and
 - adopt a new plan for the correction measures to be taken which is binding until the MTO or the adjustment path has been reached.

► **Principle 7: Independent national monitoring “institution”, “comply or explain” principle**

- According to the Fiscal Compact, each Contracting Party must set up an independent institution to monitor compliance with the correction mechanism and the carrying out of the correction measures.

- According to the Commission, such an institution should “evaluate” the following:
 - the national implementation of the provisions of the correction mechanism;
 - events justifying an activation or suspension of the correction mechanism; and
 - the progress of the correction measures.
 The evaluations must be accessible to the public.
- According to the Commission, the Contracting Party must either follow the institution’s recommendations or explain why it deviates from them (“comply or explain”).
- According to the Commission, the Contracting Party must regulate the rights of such an institution statutorily. This includes in particular the autonomy to act independently from any political instructions, recruitment according to professional skills and appropriate access to information.

Policy Context

The international Fiscal Compact will enter into force on 1 January 2013 at the earliest. In its ruling of 12 September 2012, the German Federal Constitutional Court (BVerfG) did not challenge it in the interim measures (BVerfG “ESM and Fiscal Compact”, Rs. 2 BvR 1390/12 et al.). Thereupon, the Federal President approved it on 13 September 2012 and signed the ratification deed on 27 September 2012.

Options for Influencing the Political Process

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| Leading Directorate General: | DG Economic and Financial Affairs |
| Committees of the European Parliament: | Economic and Monetary Affairs (leading); rapporteur N.N. |
| Committees of the German Bundestag: | Budget (leading); Legal Affairs, Finances |

ASSESSMENT

Economic Impact Assessment

The principles developed by the Commission and the requests addressed to the Contracting Parties are all appropriate; however, it is unclear to what extent they are legally binding. This weakens their impact.

Principle 1: Whether or not the target striven for by the Fiscal Compact – a constantly improved budgetary discipline of the Contracting Parties – is met mainly depends on the legal status of the correction mechanism, for the Fiscal Compact merely obliges Contracting Parties to enshrine a correction mechanism in national law. If subsequent governments fail to apply the correction mechanism, the other Contracting Parties have no basis for legal action. **A Contracting Party’s right to guarantee compliance with the correction mechanism in other ways than constitutional is questionable** at the very least for those Contracting Parties which have a constitution. However, **this rule is already contained in the Fiscal Compact, so the Commission cannot be held responsible for that. The Commission’s specification that it should not be possible to change the correction mechanism by means of ordinary budget laws limits the Contracting Parties’ scope of discretion and thus strengthens its legal status.**

Principle 2: The provisions contained in the SGP, for instance the deficit thresholds, are sufficient for ensuring a permanently sustainable budget. The Fiscal Compact is to improve compliance with these rules by having them additionally enshrined in national law. The Commission’s specification that the correction mechanism should be consistent with the rules of the SGP hence follows the basic concept of the Fiscal Compact. At the same time, the aim is that the rules of the SGP serve as a minimum standard for the correction mechanism. Moreover, a conflict between the correction mechanism and the SGP is thus avoided.

Principle 3: Also already contained in the Fiscal Compact is the activation of the correction mechanism should a Contracting Party deviate “significantly” – in accordance with the SGP – from the MTO and/or adjustment path. The Commission’s amendment that the correction mechanism can be activated not only when the Council identifies a “significant” deviation but also when thresholds defined by an individual Contracting Party are exceeded (“country-specific criteria”) can strengthen budget consolidation. For through such a self-commitment the correction mechanism can be activated when there is still only a mere threat of “significant” deviation, so that this never actually occurs.

Principle 4: **The proposal to define the size and timeline of deficit correction measures to be taken in the event of a “significant” deviation – already to be defined bindingly when setting up the correction mechanism – is appropriate, for this restricts the Contracting Party’s scope of discretion should such an event actually occur.** This is appropriate, for otherwise it must be feared that in the event of a “significant” deviation, the Contracting Parties will allow themselves too much time for returning to the MTO and/or adjustment path. **The suggestion that Contracting Parties that deviate “significantly” from the adjustment path should still meet their MTO within the given timeline makes it more difficult to postpone deficit reduction to the future.** For the same reason, it is to be welcomed that Contracting Parties that deviate from their MTO should as a rule attain them again in the subsequent year.

Principle 5: **It is appropriate that the correction should be achieved in particular through expenditure cuts and increased revenues** in order to correct the deviation, **for unlike measures to increase potential growth, both have a direct impact.**

Principle 6: The option to suspend the correction mechanism makes sure the Contracting Parties have the necessary fiscal flexibility to be able to respond to “exceptional circumstances”. Taking the SGP as a benchmark is appropriate, as the SGP, too, provides for a suspension of deficit requirements in the case of “exceptional circumstances”. This does not create a possible loophole. The Commission’s recommendations that when the exceptional circumstances expire the Contracting Parties should adopt a new plan for the correction measures to be taken increase the likelihood that the suspension does not lead to a permanent failure to comply with the MTO.

Principle 7: The proposed powers and statutory measures to ensure the independence **of the monitoring institution and the obligation of the single Contracting Party to either comply with their recommendations or to explain their non-compliance** (“comply or explain”) **ensure that the public can be informed regarding the sincerity and the progress of the consolidation efforts.** Thus the creditworthiness of the correction mechanism is strengthened.

Legal Assessment

Competency

The Commission was empowered by the Contracting Parties under the international Fiscal Compact to propose common principles for shaping the correction mechanism. This has been done with the Communication.

Proportionality

Unproblematic. The principles of the correction mechanism do not reach beyond the scope of action which the Contracting Parties imposed on the Commission under the Fiscal Compact.

Compatibility with EU Law

Unproblematic. It is the very principles themselves that ensure consistency with the SGP.

Compatibility with German Law

The Communication’s principles do not infringe the budget responsibility of the German Bundestag. The correction mechanism must ensure the rights of the national parliaments. Therefore, the Commission has provided only institutional provisions but no concrete material requirements as to the shaping of the budgets. Therefore, the Commission cannot intervene into **the constitutionally protected budget responsibility of the Bundestag** on the basis of the principles (see also BVerfG „ESM und Fiskalpakt“, Rs. 2 BvR 1390/12 et al., Tz. 315). The national implementation of the correction mechanism should ensure consistency with the SGP. Therefore, there is no danger that the national rules will be in conflict with the SGP, to which Germany is bound.

The basic law already contains a debt brake with a threshold of 0.35% of GDP (Art. 109, 115, 143d GG). The prevailing view is that **the German debt brake only applies to the Federal State and the Länder but not to municipalities and social insurances.** Although the Federal Constitutional Court did leave this issue unresolved (BVerfG „ESM und Fiskalpakt“, Rs. 2 BvR 1390/12 u. a., Tz. 306), the CDU/CSU and SPD fractions assumed in their draft law for the introduction of the debt brake that it does not apply to the communities and social insurances ([Bundestag-Drucksache No. 16/12410](#), p. 22). **Therefore, for the national implementation of the Fiscal Compact the structural deficit threshold must be extended to cover the general government**, including the communities and social insurances. To this end, the draft law of the Federal Government provides for “simple rulings” by way of supplementing the *Haushaltsgrundsätze-gesetz* (budgetary principles act), but not for a constitutional amendment ([Bundesrat-Drucksache No. 571/12](#), p. 12). Complying with the provisions in other ways is ensured by the *Haushaltsgrundsätze-gesetz*.

With the Stability Council Germany already has an institution that monitors the budgets of the Federal Government and *Länder* (§ 2 Stabilitätsratsgesetz – Stability Council Act). The *Stabilitätsratsgesetz* would have to be amended so that the Stability Council can act with regard to the correction mechanism. In particular, the scope of tasks of the Stability Council would have to be expanded and its independence be defined. The draft law of the Federal Government takes account of this ([Bundesrat-Drucksache No. 571/12](#), p. 2).

Conclusion

Although the principles that have been developed and the requests addressed to the Contracting Parties are all appropriate to the problem, it is unclear to what extent they are legally binding. The option provided by the Fiscal Compact to set the correction mechanism below constitutional level and thus to relativise it is impeded by the Commission’s specification that it should not be possible to change the mechanism through ordinary budgetary laws.

The possibilities to circumvent this are further narrowed by the fact that the Contracting Parties should already stipulate the size and timeline of the deficit correction when setting up the correction mechanism, so that in the event of “significant” deviation they nevertheless meet their MTO within the given timeline and they comply with the recommendations of the national monitoring institution or explain their non-compliance.

The fact that the correction measures must focus on expenditure cuts or increased revenues is appropriate, since both, unlike measures to increase potential growth, have a direct impact. The principles do not infringe the constitutionally protected budget responsibility of the German Bundestag. However, the debt brake must be extended to cover the communities and social insurances.