FISCAL COMPACT

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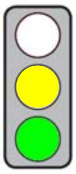
Centrum für Europäische Politik

KEY ISSUES

Objectives: The budgetary discipline of EU states is to be tightened and the coordination between them of economic policy is to be improved.

Parties affected: All citizens and politicians.



Pros: The pursued objective and most of the agreed measures – in particular the introduction of national debt brakes and facilitated sanction impositions in the deficit procedure – are a step in the right direction.

Cons: The Fiscal Compact is hardly likely to fulfil expectations:

(1) It ensures neither the introduction of the debt brake into national law nor its correct application.

(2) The states' obligation to follow the Commission's recommendations may only be interpreted as a non-justiciable political commitment; otherwise it would infringe EU law and would be invalid.

CONTENT

Title

Treaty on Stability, Coordination and Governance in the Economic and Monetary Union of 2 March 2012 ("Fiscal Compact")

Annex to the Minutes of the signing of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union: arrangements agreed by the contracting states at the time of signature concerning Article 8 of the Treaty

Brief Summary

Note: Articles quoted refer to the Fiscal Compact, unless otherwise provided for.

- **Background and objective**
  - On 2 March 2012, the EU Heads of State and Government (apart from Great Britain and the Czech Republic) signed the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union ("Fiscal Compact").
  - The Objective of the Fiscal Compact is to:
    - foster budgetary discipline;
    - strengthen the mechanism of economic policy coordination; and
    - improve economic policy governance in the euro area.
- **Legal construction and relation to EU law**
  - The Fiscal Compact is an international agreement between the participating EU States.
  - The Fiscal Compact is applied and interpreted in conformity with the EU Treaties (Art. 2 (1)). It applies only inasmuch as it is compatible with EU law (Art. 2 (2)).
  - Within a period of five years following the entry into force of the Fiscal Compact, its content is to be incorporated into EU law (Art. 16).
- **Budgetary discipline: introduction of a debt brake**

  The Contracting States undertake to transpose a debt brake into their national legal systems that is "preferably constitutional" but certainly "of binding force and permanent character" for the budgetary legislator. The debt brake consists of two components:
  - First component: the annual structural deficit must not exceed 0.5% of Gross Domestic Product (GDP) (Art. 3 (1) lit. b). Where public debt is "significantly" below 60% of GDP, the structural deficit may reach at most 1% of GDP (Art. 3 (1) lit. d).
    - Structural deficit is the public deficit cleared of cyclical effects and one-off measures as well as temporary measures.
    - Contracting States whose deficit exceeds this limit must, within a time-frame proposed by the Commission, reach their objective (Art. 3 (1) lit. b). The Commission and the Council are to evaluate their progress.
    - The Contracting States may exceed their threshold if [Art. 3 (3) lit. b in conjunction with Art. 5 (1) Regulation (EC) No. 1466/97]
      - an unusual event occurs that is outside their control and has a major impact on public finances, or
      - a severe economic downturn in the euro area or the entire Union occurs; in both cases the deviation must not endanger fiscal sustainability in the medium-term.

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- Second component: Contracting States who – with or without authorization – exceed their threshold "significantly" must take correction measures. These are automatically triggered and their content is prescribed by the Commission ("correction mechanism"; Art. 3 (1) lit. e).
- Compliance with both components is monitored through independent national institutions. The Commission will define precise rules on this (Art. 3 (2)).

► **Budgetary discipline: Monitoring the introduction of a debt brake**

- Where the Commission observes that a Contracting State fully or partially fails to transpose the debt brake obligation into national law, the matter is brought to the European Court of Justice (ECJ) (Art. 8 (1) in conjunction with No. 1 of the Annex to the Minutes).
  - The action is generally brought to court by those Contracting States who at the time of the Commission's observation hold the EU Presidency ("Trio of Presidencies") (No. 2 of the Annex to the Minutes).
  - Exempted from the duty to bring the matter to the court are Contracting States (No. 2 of the Annex to the Minutes):
    - who have also been found to be in full or partial breach of the debt brake obligation by Commissionconclusion;
    - against whom proceedings have been brought due to insufficient transposition of the debt brake obligation; or
    - who cannot act on "grounds of an overarching nature".
  - If all Contracting States of the Trios of Presidencies are affected by exemptions, the previous Trios of Presidencies must take action.
- Irrespective of the Commission's conclusion, each Contracting State "may" take action against another Contracting State if it considers that a Contracting State has fully or partially failed to comply with the debt brake obligation (Art. 8 (1)).
- Where the ECJ holds that a Contracting State has fully or partially failed to transpose the debt brake obligation into national law, it sets a transposition period (Art. 8 (1)).
- Where the Commission finds that the Contracting State has also failed to comply with the transposition period, either the Presidency or another Contracting State "may" bring an action before the ECJ and request the imposition of "financial sanctions" of at most 0.1% of GDP (Art. 8 (2)). The Contracting States "state their intention to make full use of the procedure" regarding court action (No. 6 Annex to the Minutes).
- Financial sanctions must be paid to the European Stability Mechanism if the convicted Contracting State is a euro state; otherwise they flow to the EU budget (Art. 8 (2)).

► **Budgetary discipline: Enhancing the efficiency of the Stability and Growth Pact**

- "While fully respecting" the procedural requirements of the EU Treaties, the euro states commit to support the recommendations submitted by the Commission during all Council decision relating to deficit procedures (Art. 7; for an overview of Deficit Procedures see CEP Policy Brief, in German). This is not applicable where (Art. 7)
  - the deficit procedure is initiated because the debt ratio is not being reduced fast enough; or
  - a qualified majority of euro states – under exclusion of the state concerned – is opposed to the Commission's recommendation.
- Contracting States subjected to deficit procedures must put in place structural reforms within a "budgetary and economic partnership programme" that ensure the "durable" correction of excessive deficits. The "budgetary and economic partnership programme" is subject to the Commission's and the Council's approval; its transposition is monitored by them (Art. 5).
- Contracting States with a public debt exceeding 60% of GDP must reduce the difference between their debt excess and the 60% limit by an average of 5% per year [Art. 4 in conjunction with Art. 2 Regulation (EC) No. 1467/97].

► **Strengthening economic policy coordination**

- The Contracting States introduce measures to foster competitiveness, increase employment and contribute to the long-term stability of public finances and the strengthening of the financial market stability (Art. 9).
- The Contracting States pledge to debate ex-ante and, where appropriate, coordinate "all major economic policy reforms" (Art. 11).
- The Contracting States report to the Council and the commission on the planned emissions of state bonds (Art. 6).

► **Improvement of economic policy governance in the euro area**

- The Heads of State and Government of the euro stateswill meet at least twice a year ("Euro Summit Meetings") to discuss economic policy governance in the euro area (Art. 12).

Changes to the Status quo

Note: For comparison, reference is made to the Stability and Growth Pact reformed in 2011.

- New is the commitment to introducing national debt brakes.
- The Fiscal Compact reduces the general threshold for permissible structural deficits from 1.0% to 0.5% of the GDP.
- The preconditions under which a Contracting States may exceed the threshold are not amended.
- New is the automatic correction mechanism.
- The commitment to reduce debts by 5% of GDP per year remains unchanged.
- Extended is the obligation to support the Commission's recommendations unless a qualified majority of states opposes. To date, such a rule has applied only in two cases; otherwise, the Council must approve a Commission Recommendation with a qualified majority.

Legislative Procedure

02 March 2012	Signing of the Fiscal Compact
Open	Approval by the German *Bundestag* and by the German *Bundesrat*, Publication in the German *Bundesgesetzblatt*, deposit of the Ratification Deed, entry into force

Options for Influencing the Political Process

Committees of the German Bundestags:	Budget Committee (leading)
Decision mode	Two-third majority in the Bundestag (Art. 23 Abs. 1, 79 (2) GG), two-third majority in the Bundesrat (Art. 23 Abs. 1, 79 (2) GG)

Formalities

Legal competency:	Art. 23 (1) GG
Form of legislative competency:	Exclusive Federal Competency (Art. 70 (1), 23 (1) GG)
Legislative procedure:	Approval Legislation (Art. 23 (1) GG)

ASSESSMENT

Economic Impact Assessment

Before the onset of the euro crisis, euro states assumed that the consequences of excessive public debt were nationally limited. They chose not to enforce EU rules regarding budgetary control in the Council. However, the last two years have proved that this assumption was wrong. Solvency issues in one euro state lead to a burdening of public budgets in other euro states, for instance, in the form of financial support from banks, rescue packages or lower dividends of central banks. The aim of the Fiscal Compact is to ensure that EU rules relating to national budgetary discipline are enforced.

The Fiscal Compact's **aim to tighten budgetary discipline in EU states and also the measures agreed upon are mainly a step in the right direction**. However, **the great expectations placed in this pact will be disappointed**:

The Fiscal Compact ensures neither the introduction of the debt brake into national law nor its correct application. Where it is introduced insufficiently, the Council Presidency must sue the failing Contracting State. If, however, such a Party continues to refuse to introduce it properly, despite the ECJ judgement, there is no further appeal obligation in order to effect penalties; there is only the possibility to file a suit. The correct application is also not ensured. **In particular, the other Contracting States have no rights for action where a single government does not comply with the requirements of its own debt brake**. Enshrining this in the constitution does not change this: **Even in Germany, where the Constitution and constitutional courts enjoy a particularly high degree of importance compared to other EU countries, in the past there have been unconstitutional budgets nevertheless**. Therefore, it is questionable whether or not the monitoring through national institutions such as the German Federal Court of Auditors will ensure an effective control. Hence, **compliance with the debt brake requirement depends on political will**.

The credibility of the debt brake is further reduced by the fact that since the crisis began, many measures have been enforced aimed at mitigating the impact on financially unsound euro states. This includes granting credits to ailing euro states at interest rates which were not in line with market conditions, the purchasing of bonds by the ECB and three-year ECB credits of more than one trillion euros to commercial banks, at the same time as lowering the quality requirements for eligible assets. Moreover, the debt brake does not focus on the cause of the current crisis but on its symptoms only. The real cause is the erosion of competitiveness, in particular of Southern European economies, resulting in an erosion of the tax basis of these states (see CEP Default Index). This problem is only marginally taken account of in the Fiscal Compact.

The euro states' commitment to follow the Commission's recommendations in the deficit procedure aggravates the organisation of a blocking minority in the Council, whose aim it is to prevent sanctions. The fact that such an obligation does not, however, apply to deficit procedures with an insufficient debt reduction raises doubts as to whether all Contracting States will really implement the rule prescribing an annual average 5% where debts exceed 60% of the GDP.

The "budgetary and economic partnership programme" makes it possible in future to define not only deficit targets but also the measures required for meeting these targets. Thus structural problems such as insufficient competitiveness can also be addressed. The obligation to coordinate economic policy reforms ex ante also creates counterproductive incentives. Contracting States with low-level competitiveness will try to dilute or even block competition enhancing reforms in successful states in order to alleviate their own pressure for reforms.

Disclosing the planned emission of bonds prevents all Contracting States from emitting bonds on the same day. But national debt agencies already inform themselves as to the planned emission dates, and therefore, the obligation to report to the Council and the Commission is not necessary. In fact, the fear is that it might constitute a further step towards Eurobonds (cp. CEP Policy Brief).

Legal Assessment

Competency

As an international treaty agreed upon by the participating states, the Fiscal Compact is not subject to any EU competence.

Compatibility with EU Law

The question is whether, and possibly to what extent, EU law has priority over the Fiscal Compact, thereby rendering it obsolete:

an exclusive and absolute EU competence, which might oppose the Fiscal Compact, does not exist. Although there is such a competence for the monetary policy of euro states (Art. 3 (1) lit. c TFEU), it does not cover Art. 126 TFEU: It affects the budgetary policy supervision of EU states. Furthermore, Art. 121 and Art. 136 TFEU do not give grounds for an exclusive EU competence (see for details CEP Policy Brief).

In terms of substantive legal content, the provisions of the Fiscal Compact are meant to create a culture of stability in the EU states that is also desired (but still lacking) by EU law. Therefore, from a legal point of view, they do not contradict EU law but complement the legal instruments provided for by EU law.

There are, however, questions regarding the procedural rights:

Pursuant to the EU deficit procedure, bringing an action before the ECJ (contract infringement proceedings) is on the whole ruled out (Art. 126 (10) TFEU). Such exclusion is not, however, affected by the Fiscal Compact: according to the Fiscal Compact, the ECJ may only be petitioned with the introduction of a national debt brake, and then only if the action is brought by a Contracting State, not by the Commission.

The euro states obligation to follow the Commission's recommendations in the deficit procedure – **apart from a rejection by a qualified majority – is**, at least superficially, **contradictory to EU procedural law** (Art. 126 (13) TFEU in conjunction with Art. 16 (3) TEC); this requires approval by qualified majority. From a legal point of view, there is already a contradiction between EU law and the Fiscal Compact due to the fact that the procedures deviate from each other, even though the same policy objectives are being followed. Since in the case of contradiction EU law prevails, the provision would be superfluous. However, the question is whether the Contracting States really mean this provision to be interpreted quite so harshly and in so doing provoke, as it were, a conflict of interests with primary law. Therefore, **only a "soft" interpretation is justifiable in terms of a political**, non-justiciable **commitment.** This would appear to be supported not least by the repeated subordination clauses of the Fiscal Compact (Art. 2, also Art. 7), with which the Contracting States show that they wish to prevent any conflict with EU law at all. In this interpretation, although the liability of the provision suffers, it is not possible to have both "hard" legal liability and compatibility with EU law at the same time without an amendment to the EU Treaties.

In general, far preferable would be a clear EU regulation.

Conclusion

The aim to tighten budgetary discipline in EU states and the agreed upon measures are mainly a step in the right direction. The great expectations placed in this aim will, however, be disappointed: the Fiscal Compact ensures neither the introduction of the debt brake into national law nor its application. In particular, the other Contracting States do not have the means to act where single governments do not comply with the rules of their own debt brake. Even in Germany, where the Constitution and constitutional courts enjoy a particularly high degree of importance compared to other EU countries, in the past there have been unconstitutional budgets nevertheless. The euro states' commitment to following the Commission's recommendations in the deficit procedure may be interpreted as a non-justiciable political commitment only; otherwise it would infringe EU law and be invalid.

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