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EU Fiscal Governance and the Effectiveness of its Reform

ALEXANDRE DE STREEL*

A COMMON CURRENCY area leads to multiple externalities, or spill-over effects, among its participating countries. One of these externalities relates to national fiscal policy. This is especially the case when financial markets are, on the one hand, imperfect and do not charge different risk premiums between countries according to their risk profiles, and, on the other hand, are integrated and financial institutions hold significant debts of foreign countries. In such circumstances, there is a risk that a country runs a large fiscal deficit by free-riding on the credit rating of the others.[1] To deal with this externality risk, the architects of EMU decided to constrain national fiscal policies with rules backed by sanctions.[2] Thus the TFEU imposed numerical limits on government deficit and debt (Protocol No 12 on the excessive deficit procedure), established an annual surveillance of national fiscal policies (Article 121 TFEU) and a sanction procedure when the fiscal limits were breached (Article 126 TFEU). Moreover, the TFEU also provided that a national deficit could not be monetized (Articles 123–24 TFEU) and that the EU or the Member States could not be liable for or assume the commitments of another Member

* The author wishes to thank Pierre Larouche and Federico Fabbrini for their very useful comments as well as the participants of the Conference on the Constitutionalization of European Budgetary Constraints, Tilburg, May 2013 for helpful discussions.

[1] For a discussion of this externality, P de Grauwe, *Economics of Monetary Union*, 9th edn (Oxford, Oxford University Press, 2012) 218–26. He shows that, empirically, it is not clear whether fiscal discipline is lower in monetary unions.

[2] The Maastricht negotiations were based on the Report on Economic and Monetary Union in the European Community, prepared by the Committee chaired by J Delors and presented in April 1989. On the background to the negotiations, see K Dyson and K Featherstone, *The Road to Maastricht: Negotiating Economic and Monetary Union* (Oxford, Oxford University Press, 1999). On the model of governance decided, see J Pipkörn, 'Legal Arrangements in the Treaty of Maastricht for the Effectiveness of the Economic and Monetary Union' (1994) 31 *Common Market Law Review* 263; MJ Herdegen, 'Price Stability and Budgetary Restraints in the Economic and Monetary Union: The Law as Guardian of Economic Wisdom' (1998) 35 *Common Market Law Review* 9–32; JV Louis, 'A Legal and Institutional Approach for Building a Monetary Union' (1998) 35 *Common Market Law Review* 33–76; HJ Hahn, 'The Stability Pact for European Monetary Union: Compliance with Deficit Limit as a Constant Legal Duty' (1998) 35 *Common Market Law Review* 77–100.

State (no-bailout clause: Article 125 TFEU). Thus the governance model chosen was based on the maintenance of fiscal decentralization constrained by financial markets and rules and without financial solidarity. Other models were possible, such as more centralized fiscal policy, but they were not politically feasible at the time.

The past decade has showed that the model chosen did not work well. There are several reasons for this, including fiscal rules that were poorly designed and not well implemented. When added to the other banking and macroeconomic difficulties created by the 2008 global financial crisis, this led to some Member States experiencing high levels of financial instability since 2010. In turn, this led to more financial solidarity than envisaged by the architects of EMU[3] and cast doubt on the credibility of the no-bailout clause.[4] To remedy such weaknesses, EU fiscal governance has been substantially reformed in three main waves. The first wave was the adoption in November 2011 of the 'six-pack', a set of five regulations and one directive. These make the fiscal rules stricter and improve the sanction procedure, notably by increasing their automaticity.[5] The second wave was the adoption in March 2012 of the Treaty on Stability, Coordination and Governance in the the Economic and Monetary Union (TSCG, the 'Fiscal Compact'), an international treaty concluded by 25 EU Member States outside the EU legal framework but relying very much on EU institutions.[6] This Treaty provides for the constitutionalization of the EU fiscal rules and the creation of

[3] In 2010, the European Financial Stability Facility (EFSF) with a lending capacity of €440 billion and the European Financial Stabilisation Mechanism (EFSM) with a lending capacity of €60 billion were established. They were replaced in 2012 by the European Stability Mechanism (ESM) with a lending capacity of €500 billion. On those instruments, see A de Gregorio Merino, 'Legal Developments in the Economic and Monetary Union During the Debt Crisis: The Mechanism of Financial assistance' (2012) 49 *Common Market Law Review* 1613–46; JV Louis, 'Guest Editorial: The No-Bailout Clause and Rescue Package' (2010) 47 *Common Market Law Review* 971–86.

[4] Note that the CJEU validated the ESM Treaty with regard to the non-bailout clause by adopting a teleological interpretation of the clause: 'Given the objective pursued by Article 125 TFEU, it must be held that that provision prohibits the Union and the Member States from granting financial assistance as a result of which the incentive of the recipient Member State to conduct a sound budgetary policy is diminished. … However, Article 125 TFEU does not prohibit the granting of financial assistance by one or more Member States to a Member State which remains responsible for its commitments to its creditors provided that the conditions attached to such assistance are such as to prompt that Member State to implement a sound budgetary policy': Case C-370/12 *Pringle v Ireland* [2012], judgment of 27 November 2012, nyr, [136]–[137].

[5] The six-pack was published in [2011] OJ L306. Most of its provisions entered into force on 13 December 2011. The six-pack was negotiated on the basis on the Final Report of 21 October 2010 by the Task Force on Economic Governance which was endorsed by the European Council of 28–29 October 2010. Note that the Stability and Growth Pact regulations had already been amended in 2005 to make the fiscal rules smarter: see F Amtenbrink and J de Haan, 'Economic Governance in the European Union: Fiscal Discipline Versus Flexibility' (2003) 40 *Common Market Law Review* 1075–106; JV Louis, 'The Review of the Stability and Growth Pact' (2006) 43 *Common Market Law Review* 85–106.

[6] P Craig, 'The Stability, Coordination and Governance Treaty: Principle, Politics and Pragmatism' (2012) 37 *European Law Review* 231; S Peers, 'The Stability Treaty: Permanent Austerity or Gesture Politics' (2012) *European Constitutional Law Review* 404.

a national correction mechanism next to the EU sanction procedure.[7] The third wave was the adoption in May 2013 of the 'two-pack', a set of two EU regulations that apply only to Member States whose currency is the euro. These regulations improve the national institutional framework and reinforce the Commission and Council oversight over national fiscal policies. [8]

This paper analyses these three waves of reform. The first section is descriptive and gives a brief overview of the new fiscal governance as modified by the six-pack, the TSCG and the two-pack. The second section is critical and analyses the weaknesses of the original fiscal governance and the effectiveness of the recent reforms. The third section briefly concludes.

I. OVERVIEW OF EU FISCAL GOVERNANCE

EU fiscal governance is based on several legal instruments which are closely related: (i) a number of primary EU law provisions; (ii) two EU regulations composing the Stability and Growth Pact[9] and two EU regulations reinforcing and complementing the Stability and Growth Pact for the Member States whose currency is the euro;[10] (iii) one EU directive and one EU regulation requiring minimal quality for the national institutional framework;[11] and (iv) the TSCG. This section analyses the three main components of EU fiscal governance: first, the rules constraining national fiscal policies; second, the institutions at the EU and national levels in charge of the implementation of the rules; and third, the enforcement mechanisms at the EU and national levels.

[7] The TSCG entered into force on 1 January 2012. It was negotiated on the basis of the Statement by the eurozone heads of state or government of 9 December 2011.

[8] The two-pack was published in [2013] OJ L140. Most of its provisions entered into force on 30 May 2013.

[9] Regulation 1466/97 of the Council of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies [1997] OJ L209/1 as amended by Regulation 1055/2005 and Regulation 1175/2011; Regulation 1467/97 of the Council of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure [1997] OJ L209/6, amended by Regulation 1056/2005 and Regulation 1177/2011. For an overview of the revised Stability and Growth Pact, see European Commission, 'Building a Strengthened Fiscal Framework in the European Union: A Guide to the Stability and Growth Pact' (2013) *European Economy: Occasional Paper 150*; European Commission, 'Vade Mecum on the Stability and Growth Pact' (2013) *European Economy: Occasional Paper 151*.

[10] Regulation 1173/2011 of the European Parliament and of the Council of 16 November 2011 on the effective enforcement of budgetary surveillance in the euro area [2011] OJ L306/1; Regulation 473/2013 of the European Parliament and of the Council of 21 May 2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area [2013] OJ L140/11.

[11] Directive 2011/85 of the Council of 8 November 2011 on requirements for budgetary frameworks of the Member States [2011] OJ L306/41; Regulation 479/2009 of the Council of 25 May 2009 on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community [2009] OJ L145/1, amended by Regulation 679/2010.

A. Fiscal Rules

EU law and the TSCG provide limiting rules related to actual and structural government deficit and to government debt as well as to the correction path when those limits are violated.

(i) Actual and Structural Government Deficit Rules

Each Member State must maintain its actual government deficit below 3 per cent of GDP, unless either the ratio has declined substantially and continuously and reached a level that comes close to 3 per cent, or, alternatively, the excess over 3 per cent is only exceptional and temporary and the ratio remains close to 3 per cent.[12] Moreover, each Member State must comply with a country-specific Medium Term Objective (MTO). This is a target for the structural deficit (ie the actual deficit corrected for the effects of the economic cycle as well as the one-off and temporary fiscal measures) in the medium term (ie three years). The target is determined for each Member State according to its government debt. The Stability and Growth Pact requires that the MTO must be above a floor of –1 per cent of GDP[13] and the TSCG goes further by requiring that the MTO is above –0.5 per cent of GDP (unless the ratio of government debt is below 60 per cent of GDP and the risks in terms of long-term sustainability of public finances are low).[14] This MTO rule ensures the sustainability of public finance while allowing room for budgetary manoeuvre, in particular for automatic stabilizers or public investment.

Until a Member State reaches its MTO, it must follow an adjustment path towards the MTO by reducing its structural deficit by at least 0.5 per cent of the GDP per year (or more if the Member State has a government debt above 60 per cent of the GDP or presents pronounced risks of overall debt sustainability).[15] There is an escape clause in the case of an unusual event outside the control of the Member State which has a major impact on the financial position of the general government or in periods of severe economic downturn for the eurozone or the EU as a whole. In such exceptional circumstances, the Member State may be allowed temporarily to depart from the adjustment path, provided that this does not endanger fiscal sustainability in the medium term.[16]

[12] Art 126(2) TFEU and Art 1 Protocol no 12 on the excessive deficit procedure.

[13] Art 2(a)(2) Regulation 1466/97 amended. The methodology to calculate the MTO is explained in the Specifications of the Council of 3 September 2012 on the implementation of the Stability and Growth Pact and Guidelines on the format and content of Stability and Convergence Programmes. See also European Commission (n 10).

[14] Art 3(1b) and (1d) TSCG.

[15] Art 5(1) Regulation 1466/97 amended.

[16] Art 5(1) *in fine* Regulation 1467/97 amended and Art 3(1c) and (3b) TSCG.

(ii) Government Debt Rule

Each Member State must maintain its government debt below 60 per cent of GDP, unless the ratio is sufficiently diminishing and approaching 60 per cent at a satisfactory pace.[17] If a Member State has a government debt above 60 per cent of GDP, it must reduce it at a satisfactory pace, which implies a reduction of the differential between the actual debt level and the 60 per cent of the GDP threshold at an average rate of 1/20th per year.[18] Finally, the Member States of the Eurozone must report to the Commission and the Eurogroup, ex ante and in a timely manner, on their national debt issuance plans in order to better co-ordinate the planning of such issuance.[19]

(iii) Transposition of EU Fiscal Rules into National Law

EU law provides that each Member State must enshrine in national law numerical fiscal rules which effectively promote compliance with EU government deficit and debt rules and their annual budget legislation must reflect such rules.[20] The TSCG goes further and requires that Contracting Parties transpose into national law the MTO rule and its adjustment path through provisions of binding force and permanent character, preferably constitutional, or otherwise guaranteed to be fully respected and adhered to throughout the national budgetary processes.[21]

B. Institutional Framework

The second component of the fiscal governance relates to the institutional framework. EU law and the TSCG provides for minimal quality characteristics of the national institutions and for efficient EU co-ordination and oversight.

(i) National Institutional Framework

To facilitate the control of the fiscal rules by national and EU institutions, EU law provides for minimal quality rules for the budgetary framework defined as 'the set of arrangements, procedures, rules and institutions that underlie the conduct of budgetary policies of general government'.[22]

[17] Art 126(2) TFEU and Art 1 Protocol no 12 on the excessive deficit procedure.

[18] Art 2(1a) Regulation 1467/97 amended and Art 4 TSCG.

[19] Art 8 Regulation 473/2013 and Art 6 TSCG; Section III of the Specifications of the Council of 9 July 2013 on the implementation of the two-pack and Guidelines on the format and content of draft budgetary plans, economic partnership programmes and debt issuance reports.

[20] Arts 5–7 Directive 2011/85. Such provisions do not apply to the UK.

[21] Art 3(2) TSCG.

[22] Art 2 Directive 2011/85.

Minimal Institutional Requirements Applicable to All Member States

All Member States must have in place public accounting systems comprehensively and consistently covering all subsectors of general government, based on the European System of Accounts (ESA) 95 standard and subject to internal control and independent audits.[23] Eurostat, the statistics department of the Commission, controls the quality of the national data by running dialogue and methodological visits in the Member States.[24] Member States must also adopt realistic macroeconomic and budgetary forecasts with sensitivity analysis, and must explain any significant divergences from Commission forecasts.[25] In addition, Member States must establish a credible, effective medium-term budgetary framework providing for the adoption of a fiscal planning horizon of at least three years.[26] Finally, Member States must establish appropriate mechanisms of co-ordination across subsectors of general government and promote fiscal accountability of those subsectors.[27]

Additional Institutional Requirements for Member States whose Currency is the Euro

Each Member State of the eurozone must apply a Common Budgetary Timeline with three main deadlines: (i) preferably by 15 April but no later than 30 April, adoption of a national medium-term fiscal plan; (ii) no later than 15 October, adoption of a draft budget for the forthcoming year; (iii) not later than 31 December, adoption of the budget.[28] Each Member State of the eurozone must also establish a national independent fiscal council (IFC) with three main tasks: producing or endorsing macroeconomic forecasts and possibly budgetary forecasts; monitoring compliance with national numerical fiscal rules; and monitoring the implementation of the national automatic correction mechanism in the case of violation of the fiscal rules.[29] These national fiscal councils must be structurally independent or endowed with a high degree of functional autonomy vis-à-vis the national budgetary authorities. That requires: a statutory regime grounded in national law; nomination procedures based on experience and competence; adequacy of resources; and appropriate access to information and freedom to communicate this publicly in a timely manner.[30] In other contexts,

[23] Art 3 Directive 2011/85.
[24] Arts 11–11b Regulation 479/2009 amended.
[25] Art 4 Directive 2011/85.
[26] Art 9 Directive 2011/85.
[27] Article 13 Directive 2011/85.
[28] Art 4 Regulation 473/2013.
[29] Art 5 Regulation 473/2013
[30] Art 2(1a) Regulation 473/2013. Some argue that IFCs should be independent from the government, but not necessarily from the parliaments: C Fasone and E Griglio, 'Can Fiscal Councils Enhance the Role of National Parliaments in the European Union? A Comparative analysis' in B de Witte, A Héritier and A Trechsel (eds), *The Euro Crisis and the State of the European Democracy* (Florence, European University Institute, 2013) 264.

the CJEU has shown strong support for independence by interpreting strictly this requirement and considering it not to be contrary to democratic legitimacy.[31]

(ii) EU Institutional Framework

EU institutional bodies, in particular those active in the eurozone, have been substantially reinforced by the reform of fiscal governance leading to an increased institutional differentiation between the EU and EMU.[32] Regarding bodies composed of national executives, the different levels of Member State representation has been improved. At the top, a Euro Summit, composed of the heads of state or government of those Member States whose currency is the euro and chaired by an elected president, has been created by the TSCG.[33] At the ministerial level, the Eurogroup had already been reinforced by the Lisbon Treaty[34] and it is now envisaged that it will be chaired by a full-time president.[35] At the preparatory level, the Eurogroup Working Group (EWG), which is composed of the representatives of the eurozone countries at the Economic and Financial Committee, is now chaired by a full-time Brussels-based president.[36]

Regarding parliamentary bodies, the six-pack and the two-pack establish an economic dialogue between, on the one hand, the relevant committees in the European Parliament and, on the other hand, representatives of the EU institutions involved in fiscal governance (Commission, Ecofin Council, Eurogroup, European Council) or representatives of the Member States affected by fiscal governance measures.[37] Moreover, a conference of representatives of the relevant committees of the European Parliament and representatives of the relevant committees of national parliaments has been set up by the TSCG.[38]

C. Enforcement Mechanisms

The third component of fiscal governance is the enforcement mechanisms at the EU and the national levels.

[31] See Case C-518/07 *Commission v Germany* [2010] ECR I-1885, in particular paras 30 and 46 interpreting the independence requirement for a national data protection authority provided by Art 28(1) Directive 95/46/EC of the European Parliament and of the Council of 24 October 1995 on the protection of individuals with regard to the processing of personal data and on the free movement of such data [1995] OJ L281/31.

[32] For an analysis of the integration and the differentiation caused by the EMU, see F Snyder, 'EMU—Integration and Differentiation: Metaphor for European Union', in P Craig and G de Búrca (eds), *The Evolution of EU Law*, 2nd edn (Oxford, Oxford University Press, 2011) 687.

[33] Art 12 TSCG.

[34] See Art 137 TFUE and Protocol no 14 on the Eurogroup.

[35] Point 5 of Annex I to the Euro Summit Statement of 26 October 2011: Ten measures to improve the governance of the euro area.

[36] Ibid, points 7 and 8.

[37] Article 2(a), (b) Regulation 1466/97 amended; Art 2a Regulation 1467/97 amended; Art 3 Regulation 1173/2011; Art 15 Regulation 473/2013.

[38] Art 13 TSCG.

(i) EU Enforcement Tools

Annual Multilateral Surveillance Procedure for Fiscal Imbalances

EU law provides for an annual multilateral surveillance procedure, which is integrated into the European semester.[39] This is the preventive phase of the Stability and Growth Pact foreseen by the amended Regulation 1466/97 and complemented, for the eurozone, by Regulation 473/2013.

In April, each Member State submits to the Commission its stability programme (if its currency is the euro) or its convergence programme (if its currency is not the euro).[40] In May, the Commission analyses these programmes and, on that basis, proposes country-specific recommendations for each Member State. In July, the Council adopts the recommendations (Article 121(2) TFEU) by a qualified majority and following the 'comply or explain' principle, under which the Council is expected to, as a rule, follow the proposals of the Commission or explain its position publicly.[41]

If a Member State does not comply with its country-specific recommendations, the Commission may address a warning to this Member State (Article 121(4) TFEU). The Commission may also propose a revision of the country-specific recommendations. The Council adopts the revised recommendations (Article 121(4) TFEU) by a qualified majority and following the 'comply or explain' principle. Moreover, if the Member State concerned is part of the eurozone, the Commission proposes the imposition of an interest-bearing deposit of 0.2 per cent of GDP. Such sanction is deemed to be adopted by the Council unless it decides by a qualified majority to reject it within ten days (reverse qualified majority).[42] Thus, these recommendations do not have direct binding effect as their violation cannot lead to an infringement case before the CJEU. However, they have indirect binding effect as their violation may lead to an investigation by the Commission and the imposition of sanctions by the Council. As in other EU fields (such as electronic communications), the recommendations have important legal effect through ad hoc sanction procedures. In other words, economic governance recommendations have less binding effects than those of the hard law but more binding effects than those of the (standard) soft law.

In addition, Member States of the eurozone are also subject to obligations during the second semester of the year. No later than the 15 October, they must submit to the Commission and the Eurogroup a draft budgetary plan for the forthcoming year.[43] If the Commission identifies serious non-compliance with

[39] The European semester is foreseen by Art 2(a) Regulation 1466/97 amended.

[40] Art 4 Regulation 1466/97 amended and Code of conduct of 3 September 2012 on the Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of stability and convergence programmes.

[41] Arts 2(a), (b)(2) and 6(2) Regulation 1466/97 amended.

[42] Art 4 Regulation 1173/2011.

[43] Art 6 Regulation 473/2013; Section II of the Specifications of the Council of 9 July 2013 on the

EU fiscal rules, it requests within two weeks the submission of a revised draft budgetary plan.[44] Otherwise, the Commission adopts in November an opinion on those draft budgetary plans.

Corrective Procedure: The Excessive Deficit Procedure

If a Member State violates EU fiscal rules, the Council may place this state under an excessive deficit procedure (EDP) which gives the Commission and the Council significant powers to force Member States to comply with their fiscal obligations.[45] The EDP follows a specific timetable that is not necessarily aligned with the EU semester. The EDP is described in Article 126 TFEU, clarified by the amended regulation 1467/97 (the corrective phase of the Stability and Growth Pact) and complemented, for the eurozone, by Regulation 473/2013.

The EDP starts with a proposal from the Commission to place the Member State under EDP and adopt budgetary recommendations with two main elements: a correction date by which the actual government deficit must be below 3 per cent of GDP, and an annual reduction path for the structural deficit.[46] The Council adopts the decision on the existence of an excessive deficit and the budgetary recommendation by qualified majority and under the 'comply or explain' rule (Article 126(6) and (7) TFEU).[47] However, when the EDP is opened against a Member State whose currency is the euro and on the basis of the deficit rule, the TSCG requires that Member States support the Commission proposal unless a qualified majority of them oppose.[48] In practice, that means the Council decides by reverse qualified majority.

If the Member State concerned is part of the eurozone, it presents to the Commission and to the Council an economic partnership programme describing the policy measures and structural reforms that are needed to ensure an effectively durable correction of the excessive deficit.[49] It is also subject to far-reaching reporting requirements to the Commission.[50] Moreover, if the Member State has previously been condemned during the preventive phase of the Stability and Growth Pact or violates significantly EU fiscal rules, the Commission proposes

implementation of the Two-pack and Guidelines on the format and content of draft budgetary plans, economic partnership programmes and debt issuance reports; Communication from the Commission of 27 June 2013, Harmonized framework for draft budgetary plans and debts issuance reports within the euro area COM(2013) 490.

[44] Art 7 Regulation 473/2013.

[45] Also European Commission (2013b) and (2013c).

[46] Art 3(2) Regulation 1467/97 amended.

[47] Art 2a(1) Regulation 1467/97 amended. When an EDP is proposed against a Member State whose currency is the euro, only the other Member States whose currency in the euro can vote: Arti 139(4b) TFEU.

[48] Art 7 TSCG.

[49] Art 9 Regulation 473/2013 and Art 5 TSCG; Section IV of the Specifications of 1 July 2013 on the implementation of the Two-pack and Guidelines on the format and content of draft budgetary plans, economic partnership programmes and debt issuance reports.

[50] Art 10 Regulation 473/2013.

the imposition of an non-interest-bearing deposit amounting to 0.2 per cent of its GDP. This sanction is deemed to be adopted by the Council unless it decides by a qualified majority to reject the Commission's recommendation within ten days.[51]

If the Member State does not comply with the Council budgetary recommendation to end the excessive deficit, the Commission needs to establish that no effective action has been taken. The Council decides on the failure to take effective action following the 'comply or explain' rule and acting by reverse qualified majority if the Member State concerned is part of the eurozone and by qualified majority otherwise (Article 126(8) TFEU).[52] Moreover, if the failing state is part of the Eurozone, the Commission proposes the imposition of a fine of 0.2 per cent of its GDP, which is deemed to be adopted by the Council unless it decides by a qualified majority to reject the Commission's recommendation within 10 days.[53] The Commission also proposes to give notice to the Member State concerned to take, within a specified time limit, necessary measures for deficit reduction in order to remedy the situation. The Council decides by reverse qualified majority and following the 'comply or explain' rule (Article 126(9) TFEU).[54] If a eurozone Member State persists in failing to apply the budgetary recommendations, it may be sanctioned by the Council with a fine of up to 0.5 per cent of its GDP and other sanctions such as a revision of the loan policy by the European Investment Bank (Article 126(11) TFEU). Alternatively, if the failing state is not part of the eurozone but benefits from the cohesion fund, the Council may decide to suspend any commitments from the fund until the state concerned complies with its fiscal obligations.

(ii) National Enforcement Tools

As a complement to the EPD, EU law also requires the establishment of a national correction mechanism to increase the effectiveness of the fiscal rules. Directive 2011/85 provides that the national fiscal rules adopted by Member States must entail effective and timely monitoring of compliance with the rules, based on reliable and independent analysis carried out by independent bodies as well as the consequences of non-compliance.[55] However, such obligations are vague because the legal basis of the directive on the budgetary framework (Article 126(14) TFEU) does not allow the imposition of precise and extensive obligations.

[51] Art 5 Regulation 1173/2011.

[52] Art 126(8) TFEU provides for qualified majority rule, but the application of Art 7 TSCG leads to a reverse qualified majority.

[53] Art 6 Regulation 1173/2011.

[54] Art 126(9) TFEU provides for qualified majority rule, but the application of Art 7 TSCG leads to a reverse qualified majority. This step of the EDP does not apply to Member States whose currency is not the euro: Art 139(2b) TFEU.

[55] Art 6 Directive 2011/85.

The TSCG goes further by providing that the Contracting Parties must adopt a national correction mechanism which is triggered automatically in case of significant deviation from the MTO or the adjustment path towards it.[56] The mechanism must be based on seven common principles adopted by the Commission.[57] Those principles provide that the correction mechanism is activated in case of significant deviation from the MTO adjustment path[58] and can only be suspended when the conditions for an escape defined in EU law are met,[59] and that the correction must be proportionate to the deviation and must be monitored by an independent fiscal council. Like the MTO rule, such a correction mechanism must be included in provisions of binding force and permanent character, preferably constitutional, or otherwise guaranteed to be fully respected and adhered to throughout the national budgetary processes.[60] To ensure that the Contracting Parties transpose the MTO rule and the automatic correction mechanism into their national laws, such transposition is monitored by the Commission and subject to the adjudication of the CJEU.[61]

II. EFFECTIVENESS OF EU FISCAL GOVERNANCE AND ITS RECENT REFORMS

Compliance with the EU fiscal rules has varied over time. During an initial period, when the Member States were not yet part of the eurozone, the rules were relatively well respected because of the perceived political and economic benefits of being part of the eurozone. Once Member States had been admitted to the eurozone, however, compliance with the rules weakened substantially because there was no perceived risk of being excluded from the monetary zone and the financial markets no longer discriminated according to the differing risk profiles of the individual Member States.[62] This contributed to increasing economic divergence within the eurozone.[63]

[56] Art 3(1e) TSCG.

[57] Communication from the Commission of 20 June 2012, Common principles on national fiscal correction mechanisms COM(2012) 342.

[58] Art 6(3) Regulation 1466/97 amended stating that the deviation is significant when it is at least 0.5% of GDP in a single year or at least 0.25 % of GDP on average per year in two consecutive years.

[59] Art 5(1) Regulation 1466/97 amended: an unusual event outside the control of the Member State concerned which has a major impact on the financial position of the general government or periods of severe economic downturn for the euro area or the Union as a whole.

[60] Art 3(2) TSCG.

[61] Art 8 TSCG.

[62] For an evolution of the spreads of ten-year government bond vis-à-vis Germany between 1991 and 2011, see de Grauwe (n 1) 219.

[63] For an analysis of the divergences in the competitive positions in the Eurozone, see among others de Grauwe (n 1) 129.

A. The Weaknesses of Fiscal Governance and its Reform

Such poor compliance was also due to several weaknesses in the design of the EU fiscal governance established by the TSCG and the Stability and Growth Pact regulations. The following paragraphs review such weaknesses and the improvements made by the recent reforms of economic governance (six-pack, TSCG and two-pack).

(i) Economic Relevance of the Fiscal Rules

The 3 per cent actual deficit limit and the 60 per cent debt ceiling had no strong economic justification, and have even been claimed to be stupid by former Commission President Romani Prodi. Indeed what is relevant is the sustainability of the public finances as captured by the MTO rule and its adjustment path. Therefore, the shift of focus from the actual deficit rule to the MTO rule, initiated by the first reform of the Stability and Growth Pact regulations in 2005 and reinforced by the six-pack and the TSCG, is welcome. However, those smarter rules are more difficult to apply because the calculation of the structural deficit is complex and methodologies are subject to debate among economists. Moreover, they are less transparent and less easy to explain to the general public, hence the case for painful socioeconomic reforms to meet those rules is more difficult to make. An additional improvement to the rules would be to differentiate between public expenditures for productive investment and expenditures which do not generate return in the future.[64]

(ii) Quality Budgetary Data and Macroeconomic Forecasts

The fiscal rules cannot be applied properly, as shown in the case of Greece, if the national and EU institutions cannot rely on complete, reliable, timely and consistent statistical data as well as on independent macroeconomic forecasts. The recent reforms improve the quality of the data by conferring additional investigative powers on Eurostat[65] and providing for sanction if it is found that statistics have been manipulated.[66] These reforms also improve the quality of the forecasts by requiring, for the eurozone Member States, that forecasts are produced or endorsed by an independent national fiscal council.[67]

[64] In that regard, see European Commission, 'The Quality of Public Expenditures in the EU' (2012) *European Economy: Occasional Paper 125*.

[65] Arts 11–11b of the Regulation 479/2009 amended.

[66] Art 8 Regulation 1173/2011.

[67] Arts 2(1)(b) and 4(4) Regulation 473/2013. The usefulness of the Independent Fiscal Councils has been shown in X Debrun, D Hauner and M Kumar, 'Independent Fiscal Agencies' (2009) 23 *Journal of Economic Surveys* 44.

(iii) National Ownership

Initially, the EU fiscal rules were poorly owned by the national institutions. In most Member States, they were not transposed into national law, and no national institution was specifically in charge of their implementation. However, national ownership of EU fiscal rules is one of the key requirements for the success of EMU because fiscal policies remain decentralized and the Commission alone does not have sufficient knowledge, expertise, political capital and legitimacy to ensure that all Member States comply with EU fiscal rules. Thus, one of the main objectives of the recent reforms was to increase the ownership of fiscal rules. First, the six-pack (Directive 2011/85) provides minimal requirements for the national fiscal framework, in particular by imposing national fiscal rules incorporating some of the EU rules. Then, the TSGC requires the transposition of the MTO rule and national correction mechanism into national law preferably at the constitutional level. Finally, the two-pack (Regulation 473/2013) requires the establishment of an independent fiscal council with an extensive monitoring role. It is now up to the Commission, as the guardian of EU law (and of some TSCG provisions), to ensure that Member States implement and apply correctly Directive 2011/85, Regulation 473/2013 and the TSCG. If this is achieved, the Commission could then partner with independent national institutions to promote fiscal responsibility.

An additional improvement could be the establishment of an European network made of the national fiscal councils and the Commission in order to strengthen independent fiscal council, to exchange best practices, and ultimately to contribute to the diffusion of fiscal discipline within each Member State. Such a network of national authorities has been used successfully in the network industries such as electronic communications with the Body of the European Regulators for Electronic Communications (BEREC)[68] or energy with the Agency for the Cooperation of Energy Regulators (ACER).[69] Those networks of authorities contributed to the acceptance of a new liberalization policy paradigm promoted by the EU institutions, and often opposed by the majority of the Member States, and led to an appropriate implementation of the paradigm. To be sure, there are important differences between economic governance and the regulation of network industries as the former carries more political importance than the latter and the role of the independent fiscal council is merely advisory while the role of national regulatory authority is regulatory, but it remains that the usefulness of the network of authorities in energy or electronic communications offers important lessons for the role and the organization of the independent fiscal councils.

[68] Regulation 1211/2009 of the European Parliament and of the Council of 25 November 2009 establishing the Body of European Regulators for Electronic Communications (BEREC) and the Office [2009] OJ L337/1.

[69] Regulation 713/2009 of the European Parliament and of the Council of 13 July 2009 establishing an Agency for the Cooperation of Energy Regulators [2009] OJ L211/1.

(iv) Typology of the Sanctions

Initially, the sanctions foreseen by the Treaty were of three main types:

- Reputational: a sanction of this kind increases transparency which, in turn, leads to political as well as financial incentives (through an increase of a Member State's borrowing costs) to comply with the rules. Unfortunately, such sanctions do not work very well as financial markets are imperfect and tend to underreact (before the euro crisis) or overreact (after the euro crisis) to financial information.
- Suspending or terminating the allocation of EU funds. In particular, the European Investment Bank may reconsider its lending policy,[70] and cohesion funds may be suspended.[71] Such sanction can be effective and has been applied successfully against Hungary in 2012.[72]
- Imposition of fines. The credibility and the effectiveness of fines is a complex matter. If the Member State is able to pay the fine without undermining its financial stability, the sanction is credible; hence the threat of a fine provides an incentive to comply with the fiscal rules. This has been shown by Belgium which improved its fiscal adjustment plan in June 2013 due to the threat of being fined by the Council.[73] Conversely, if the Member State is unable to pay the fine or if the imposition of the fine jeopardizes its financial stability, the sanction is not credible. In other words, a fine is only effective if it is imposed or threatened to be imposed early in the surveillance procedure when the Member State does not face a liquidity or solvency crisis.

The recent reforms improve the design of the sanctions. First, the possibility of suspending or terminating transfer of EU funds will be extended to all types of structural funds. Second, the financial sanctions are more graduated (going from interest-bearing deposit to non-interest-bearing deposit to fine) and can be imposed earlier in the excessive deficit procedure and even during the preventive phase of the Stability and Growth Pact. Some, notably Germany, have proposed another type of sanction, namely the suspension of the voting right in the Council. However, this new type of sanction requires a Treaty change.

[70] Art 126(11) TFEU.

[71] Art 4 Regulation 1084/2006 of the Council of 11 July 2006 establishing a Cohesion Fund [2006] OJ L210/79, as amended.

[72] Implementing Decision 2012/156 of the Council of 13 March 2012 suspending commitments from the Cohesion Fund for Hungary with effect from 1 January 2013 [2012] OJ L78/19; and Implementing Decision 2012/323 of the Council of 22 June 2012 lifting the suspension of commitments from the Cohesion Fund for Hungary [2012] OJ L165/46.

[73] See Press Speaking Points of 29 May 2013 by Vice-President Rehn, SPEECH/13/481; Decision 2013/370 of the Council of 21 June 2013 giving notice to Belgium to take measures for the deficit reduction judged necessary in order to remedy the situation of excessive deficit [2013] OJ L190/87.

(v) Decision-Making Process for Sanctions

Initially, EU sanctions were proposed by the Commission and decided upon by the Council under qualified majority voting. Inevitably, this led to intense political bargaining between, on the one hand, the Member State susceptible to sanction, and, on the other, the Commission and the other Member States. This was the case during the Ecofin meeting of November 2003 when France and Germany managed to convince a blocking minority of Member States to oppose the Commission proposals for Council decisions to step up the excessive deficit.[74] Moreover, the adjudicating power of the CJEU, with its independence and objectivity, was very limited by the Treaty.[75]

The recent reforms have improved the decision-making process of the sanctions adopted at EU and national levels. Regarding EU sanctions, a distinction should be made between the decision-making process within the Commission (to propose the sanction) and that within the Council (to impose the sanction). Within the Commission, an extensive habilitation has been granted to the Commissioner for Economic and Monetary Affairs and the Euro in order to increase the independence of the decision-making process.[76] Within the Council, most of the sanctions imposed against a Member State whose currency is the euro are decided by reverse qualified majority in order to reduce the possibility of bargaining between Member States. Based on an empirical analysis of other procedures where the reverse qualified majority is applied, Van Aken and Artige show that the change in voting rule has increased substantially the probability of adoption, hence the automaticity in the sanctions proposed by the Commission.[77] In turn, this reinforces the role of the Commission in proposing the sanctions. Regarding national sanctions, Directive 2011/85, but more importantly the TSCG and Regulation 473/2013, provide that they should be automatic[78] and monitored by the independent fiscal council.[79]

However, some problems remain. Regarding the decision-making process within the Commission, there is a tension between the need to reduce the political influence of Member States on Commissioners and the requirement to ensure collegiality among Commissioners. The extensive habilitation of the Euro Commissioner may tilt the balance too much in the first direction. Moreover, the criteria used by the Commission to assess the overall situation of a Member State and decide to propose a sanction are not sufficiently transparent and may

[74] The meeting is summarized in the press release of the Council meeting of 25 November 2003. The Commission requested the annulment of such deliberation at the CJEU, but partly lost its case: Case C-27/04 *Commission v Council* [2004] ECR I-6649. This case triggered the 2005 reform of the Stability and Growth Pact regulations.

[75] Arti 126(10) TFEU.

[76] See Commission press release of 27 October 2011, IP/11/1284.

[77] W Van Aken and L Artige, 'Reverse Majority Voting in Comparative Perspective: Implications for Fiscal Governance in the EU' in B de Witte, A Héritier and A Trechsel (eds), *The Euro Crisis and the State of the European Democracy* (Florence, European University Institute, 2013) 129.

[78] Art 3(2) TSCG.

[79] Art 5(2) Regulation 473/2013.

Table 1. Weaknesses of the original EU fiscal governance and improvements

Weakness	Original system	Improvements by the reforms	Possible additional improvements
Economic relevance of fiscal rules	Actual deficit: same limit for all Member States	Introduction of the Medium Term Objective (MTO): defined in structural terms, on a medium-term basis, and specific to each Member State to ensure the sustainability of its public finances	Distinction between productive and non-productive public investment
Quality of data and forecasts		• Additional investigation powers for Eurostat • Establishment of independent fiscal councils (IFCs)	
National ownership		• Minimum quality for the national budgetary framework • Transposition of the MTO rule into national law • Establishment of an automatic correction mechanism when fiscal rules are violated • Establishment of IFC	Establishment of a network with Commission and IFCs
EU sanction types	• Reputational • Suspension or termination of EU funds • Fines	Financial sanctions are more graduated and imposed earlier	Introduction of an additional sanction consisting in the suspension of voting right
Decision-making process for EU sanctions	• Commission • Council (QMV)	• Habilitation Commissioner for Euro • Council (RQMV)	• Better guarantee for collegiality within the Commission • More transparency for the economic criteria used by the Commission to decide to propose sanctions against the Member States • Possible more adjudicating role for the Court of Justice
Decision-making process for national sanctions	Effective deficit: same for all	National correction mechanism should be based on seven common principles proposed by the Commission	Principles may be reinforced

raise suspicion of discrimination between Member States (eg according to their size). This is all the more important given the enhanced role of the Commission resulting from the reverse qualified majority and the 'comply or explain' rules applicable in the Council. Regarding the national sanction, it is not clear how the automatic requirement will be applied in practice. In particular, it remains to be seen how and by which institution the activation or the suspension of the correction will be decided and what role will be played by the independent fiscal councils.

B. Towards more Radical Reforms

In order to ensure the sustainability of the EMU, additional reforms will probably be needed, first to complement to current governance model, and then to change the model of governance.[80]

(i) Improving Legitimacy of the Current Model of Governance

The first additional reform is to focus on legitimacy as much as on effectiveness. There is indeed a risk that the recent reforms will backfire because of their legitimacy gaps,[81] leading to a rejection by citizens of the new fiscal governance. The perception of legitimacy gaps may be exaggerated or even fuelled by national politicians willing to shift the blame of painful structural reforms on EU institutions, but in politics perception is as important as reality. The first legitimacy issue is that the fiscal rules are constraining the budgetary power of national parliaments. Such constraint exists since the adoption of the Stability and Growth Pact has become more important and visible with the recent reforms. The second legitimacy issue is the increasingly important role of the European Commission (due to the reversed qualified majority voting and the 'comply or explain' rules applicable in the Council)[82] without a parallel increase in parliamentary oversight.

The Four Presidents Report adopts a simple guiding principle that democratic control and accountability should occur at the level at which the decisions are taken.[83] However, legitimacy must be addressed more forcefully. First, the justi-

[80] See also the Communication from the Commission of 28 November 2012, 'A Blueprint for a Deep and Genuine Economic and Monetary Union' COM(2012) 777.

[81] For a description of the legitimacy gaps, see among others, R Baratta, 'Legal Issues for the "Fiscal Compact": Searching for a Mature Democratic Governance of the Euro' in B de Witte, A Héritier and A Trechsel (eds), *The Euro Crisis and the State of the European Democracy* (Florence, European University Institute, 2013) 31; and F Scharpf, 'Monetary Union, Fiscal Crisis and the Preemption of Democracy', Max Planck Institute for Study of Societies Discussion Paper 11/11 (2011).

[82] The legitimacy issue resulting for the introduction of the reverse qualified majority is also analysed by Van Aken and Artige (n 75).

[83] Report of 5 December 2012 by Van Rompuy, Barroso, Draghi and Juncker, 'Towards a Genuine Economic and Monetary Union', 13.

fication of the constitutionalization of fiscal rules and the constraint on parliaments' fiscal power must be better explained, in particular that EU constraint replaces the previous monetary constraint (risk of devaluation) existing before the common currency and aims to protect future generations by limiting the short-term bias of policymakers.

Second, dialogues between institutions should be enhanced to raise awareness of the effects of the budgetary decision between Member States, thereby facilitating the internalization of fiscal cross-country externalities. Dialogues may take different directions. They may be vertical between EU and national executives as well as between EU and national parliaments (as provided for in the interparliamentary conference set up by the TSCG). Dialogues may be diagonal between the European Parliament and national executives (as foreseen in the economic dialogue set up by the six-pack and the two-pack) as well as between EU executive and national parliaments. They may also be horizontal between national parliaments, in parallel with the well-established horizontal dialogue between national executives within the Council.

Third, the oversight of parliamentary bodies over their executives should be strengthened.[84] At the EU level, the European Parliament should be able to supervise Commission actions in economic governance. At the national level, the parliaments may, thanks to the objective analysis of the newly established fiscal councils, be able to better exercise their budgetary scrutiny and oversight.[85]

(ii) Towards a (Not So Radically) New Governance Model

The second additional reform is to complement the current governance model (decentralization and rules backed by sanctions) with other models. One option is to back the rules by a mix of sanctions (sticks) and incentives (carrots). This is the logic of the Competitiveness and Convergence Instrument mentioned in the Four Presidents Report,[86] and recently proposed by the Commission.[87] Member States that undertake structural reforms to improve their public finances in the long run, while incurring short-term costs, could receive financial incentives from the EU or the eurozone.

[84] Also in this sense, not surprisingly the European Parliament (Resolution of the European Parliament 2012/2151 of 20 November 2012 with recommendations to the Commission on the report of the Presidents of the European Council, the European Commission, the European Central Bank and the Eurogroup, 'Towards a Genuine Economic and Monetary Union', point 9); Baratta (n 81).

[85] Fasone and Griglio (n 30).

[86] Ibid 7. Also Resolution of the European Parliament 2012/2151 of 20 November 2012 with recommendations to the Commission on the report of the Presidents of the European Council, the European Commission, the European Central Bank and the Eurogroup 'Towards a Genuine Economic and Monetary Union', point 12.

[87] Communication from the Commission of 20 March 2013, The introduction of a Convergence and Competitiveness Instrument COM(2013) 165.

(iii) Towards a (Radically) New Governance Model

A more radical option would be to centralize some fiscal policies at the EMU (or EU) level as is the case in nearly all currency unions. There are different possibilities for centralizing fiscal policies. One of them is to establish a budget at EMU (or EU) level with insurance characteristics and stabilization functions in case of asymmetric shocks between the Member States.[88] Such a budget and insurance scheme may be provided for financial institutions with the establishment of a common resolution and deposit guarantee mechanism.[89] Another budget and insurance scheme may be foreseen for the labour market with the establishment of a common employment benefit scheme.[90] Another possibility would be the common issuance of eurobonds, to be guaranteed by all the participating Member States. In that regard, several possibilities have been proposed.[91] One of them is the blue bond:[92] Member States can participate in a joint eurobond up to 60 per cent of their GDP (blue bond), while debt above 60 per cent would be issued as a national bond (red bond), with a seniority of the blue bonds over the red bonds.

If those more radical proposals can be justified economically provided they are designed carefully to alleviate moral hazard between the Member States, they can only be acceptable politically with a strong sense of common purpose and an intense feeling of belonging to the same Community, what de Grauwe calls the 'deep variable'.[93] As observed by Habermas:

> If one wants to preserve the Monetary Union, it is no longer enough, given the structural imbalances between the national economies, to provide loans to over-indebted states so that each should improve its competitiveness by its own efforts. What is required is solidarity instead, a cooperative effort from a shared political perspective to promote growth and competitiveness in the euro zone as a whole. Such an effort would require Germany and several other countries to accept short and medium-term negative redistribution effects in its own longer-term self-interest, a classic example of solidarity.[94]

[88] Report of 5 December 2012 by Van Rompuy, Barroso, Draghi and Juncker, 'Towards a Genuine Economic and Monetary Union', 7; de Grauwe (n 1) 128; H Enderlein et al, *Completing the Euro: A Roadmap towards Fiscal Union in Europe* (Notre Europe, 2012) 30.

[89] See the proposals discussed for the banking union.

[90] This fund could be financed by the Member States or their national security systems and activated when one Member State faces an asymmetric macroeconomic shock leading to an increase in its short-term unemployment rate: S Dullien and F Fichtner, 'A Common Unemployment Insurance System for the Euro Area' [2013] *DIW Economic Bulletin* 9.

[91] Green Paper of the Commission of 23 November 2011 on the feasibility of introducing Stability Bonds COM(2011) 818.

[92] P De Grauwe and W Moesen, 'Gains for All: A Proposal for a Common Eurobonds' [2009] *Intereconomics*; J Delpla and J von Weizsäcker, 'The Blue Bond Proposal', Bruegel Policy Brief(2010).

[93] De Grauwe (n 1) 132.

[94] J Habermas, 'Democracy, Solidarity and the European Crisis', lecture delivered at the University of Leuven on 26 April 2013.

III. CONCLUSIONS

In 1992 EU fiscal governance was based on fiscal decentralization constrained by rules (limits of 3 per cent government deficit and 60 per cent government debt), compliance with which was monitored annually and violations of which were sanctioned (via the EDP). Financial solidarity was minimal. The euro crisis and the high level of financial instability of some Member States have shown the severe flaws of such a governance model: the fiscal rules were sometimes inappropriate and often poorly implemented. Inevitably, then, the crisis led to more financial solidarity than expected.

To remedy those flaws, EU fiscal governance has been substantially reformed by the six-pack in 2011, the TSCG in 2012 and the two-pack in 2013. Such reforms, which were probably the only politically feasible options, have improved the three components of governance: on rules, they make the fiscal objectives and limits smarter; on institutions, they improve the quality of data and forecasts needed to apply properly the rules, and ensure a better national ownership; on enforcement, they improve the design and the decision-making process of the sanctions at EU level and create an national correction mechanism. All of this can still be fine-tuned: the fiscal rules could better differentiate between productive and less productive public investment, a network of the Commission and the newly established national fiscal councils could be set up, and the decision-making process and the criteria used by the Commission in proposing the sanctions could be made more transparent.

However, more fundamental reforms are needed to ensure the sustainability of EMU. The legitimacy of the new EU surveillance and sanctions tools should be improved in several ways: explaining better the rationale for the constitutionalization of the fiscal rules, enhancing dialogue between EU and national bodies (economic dialogue, etc.) as well as among national institutions (parliament, independent fiscal councils, etc), increasing the EU parliamentary oversight where the Commission power has been enhanced. Other models of governance may also be developed. The sticks of fiscal governance (sanctions) should be complemented with carrots (financial incentives). More centralization of fiscal policy could be by with the creation of a eurozone budget to absorb asymmetric macroeconomic shocks or the issuance of common eurobonds. Those reforms may be difficult to agree today, but the risk is that the fatigue of the citizens towards the European Union, of which the economic governance is one of the most visible parts, and the rise of nationalism within the Member States, will make any reform even more difficult tomorrow.