



The Fiscal Compact Treaty

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Introduction

The Senior European Experts paper *Reforming European Economic Governance* (April 2011) explained how the EU and the eurozone was responding to economic and fiscal difficulties in the EU. The Fiscal Compact Treaty is part of a series of steps designed to restore stability to the eurozone; its value therefore needs to be assessed in the context of those other measures. Details of some of the other measures can be found in the SEE paper *The Eurozone Crisis: An Update*.¹

This briefing paper explains the agreement reached by the eurozone countries on 9th December 2011 when Germany, in particular, argued very strongly that the emergency measures already decided needed to be bolstered by long-term measures to ensure greater fiscal discipline. The resulting Treaty was subsequently agreed by 25 Member States at the January 2012 European Council. The United Kingdom, along with the Czech Republic, has so far declined to sign it.

Background

During the summer and autumn of 2011 it became clear that the markets would not accept that sufficient action had been taken to prevent eurozone countries from defaulting on their debts. It became progressively more difficult for eurozone states with high levels of public debt to sell fresh bonds at affordable rates of interest. Three concerns arose:

- that the new mechanism agreed for providing financial support to eurozone countries from mid-2013 – the European Stability Mechanism – was unlikely to have sufficient resources to cope with a crisis in one of the larger members, such as Italy;
- that the current EU treaties did not provide adequate rules on fiscal issues in eurozone members and new rules providing for a greater level of economic integration were required;
- that the ban on the EU taking on the debts of the Member States (Article 123 of TFEU) prevented the ECB from acting as a lender of last resort and intervening in the manner in which the US Federal Reserve and the Bank of England had done with their quantitative easing measures.

The European Commission published a green paper in November 2011 outlining proposals for jointly issued euro debt bonds.² However, the German Chancellor made it clear that Germany would not accept a change to the powers of the ECB to enable it to buy public debt. This meant that any treaty changes agreed at the December European Council would

¹ Senior European Experts, *The Eurozone Crisis: An Update*, March 2012

² European Commission, *Green Paper on the feasibility of introducing Stability Bonds*, COM (2011) 818 final, 23 November 2011

be limited to toughening the fiscal rules of the eurozone and possibly to the enhancement of the financial stability facility.

The December 2011 Agreement

Following the decision of the UK government to block negotiations on amendments to the EU treaties, the other Member States agreed a joint statement on new fiscal rules. This document formed the basis for the negotiation of the subsequent inter-governmental treaty agreed in January 2012 by 25 Member States.

The eurozone heads of state or government December statement promised action in two areas:

- fiscal rules and economic policy co-ordination; and
- strengthening the financial stability tools in response to the current crisis.³

The leaders promised a new “fiscal compact” with far greater economic policy co-ordination designed to “foster fiscal discipline and deeper integration in the internal market as well as stronger growth, enhanced competitiveness and social cohesion”. The leaders agreed that to make the new fiscal compact work it would have to be incorporated into a new legal framework for the eurozone.

The Final Treaty

The Treaty on Stability, Co-ordination & Governance in the Economic and Monetary Union was agreed at a meeting of 25 Member States in Brussels on January 30th 2012.⁴ Its provisions do not differ substantially from the principles agreed in the December 2011 statement with the important exception of the excessive deficit procedure (see below).

Fiscal Rule

Article 3 of the Treaty sets out the new rule on balanced budgets for the countries that have signed the Treaty (*i.e.* not just the eurozone countries):

- general government budgets should be balanced or in surplus;
- this principle would be met if, as a rule, the annual structural deficit was at its country-specific medium-term objective (as defined by the Commission) with a lower limit of a structural deficit of 0.5 per cent of GDP at market prices;
- eurozone countries would be given time to converge towards their own medium-term objective according to a calendar proposed by the Commission but deviations from the agreed path might be permitted in exceptional circumstances (such as a severe economic downturn as defined by the Stability & Growth Pact);
- the structural deficit could be allowed to grow to one per cent of GDP provided the ratio of government debt to GDP ratio was below 60 per cent and “where risks in terms of long-term sustainability of public finances are low”;

³ See European Council, *Statement by the Euro Area Heads of State or Government*, 9 December 2011

⁴ *Treaty on Stability, Coordination and Governance in the Economic and Monetary Union*, 2 March 2012

- the correction mechanism in the Treaty would be triggered automatically by failure to hit the target or by deviations from the agreed path towards it.

For some countries, the suggestion in the December statement that each eurozone member country should have this rule written into their constitution raised serious problems. The compromise was that the Treaty states that this rule should be incorporated into domestic law “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” (Article 3 (2)).

Article 8 of the Treaty sets out the procedure to be followed if a country fails to adopt the above provision. The European Commission or one of the signatory countries can refer a country that has failed in its opinion to implement Article 3 (2) to the Court of Justice. The Court is given the power to impose a fine of up to 0.1 per cent of its GDP. This use of the Court is justified by reference to Article 273 of the Treaty of the Functioning of the European Union which provides for Member States to refer disputes between themselves to the Court of Justice for adjudication.

Excessive Deficit Procedure

Protocol 12 of the EU treaties lays down a procedure to be followed if a Member State has an excessive deficit – that is a planned or actual public deficit of 3 per cent or more of GDP or the government debt to GDP ratio exceeds 60 per cent. The December statement proposed that this already established procedure should be tightened in the case of the eurozone countries so that if the 3 per cent ceiling were breached there would be automatic consequences. The steps or sanctions recommended by the Commission would be adopted unless there was a qualified majority of eurozone countries *against* them (a so-called “reverse majority”).

This plan had to be abandoned because it would have required a change to the EU treaties. The idea may be progressed by agreement with all Member States in future. Instead Article 7 of the Treaty states that the eurozone countries “commit to support the proposals or recommendations submitted by the European Commission” when the Commission finds that a member country has broken the excessive deficit rules in the EU treaties. But this can only be overturned by a qualified majority.

All EU Member States had already agreed at the March 2011 European Council to revise the excessive deficit rule so that:

States with debt in excess of 60% of GDP must reduce the amount by which their debt exceeds the threshold by at least 1/20th per year over three years.

This rule is enshrined in Article 4 of the new Treaty in respect of the countries signing the Fiscal Compact Treaty.

Article 5 states that a country that had signed the new Treaty and was in the excessive deficit procedure would have to submit to the Commission and Council for endorsement an economic programme setting out the structural reforms needed to ensure “to ensure an effective and durable correction of its excessive deficit”; these programmes would be monitored by the Commission and the Council.

Economic Policy Co-ordination & Governance

Articles 9 to 11 of the new Treaty deal with the co-ordination of economic policy in future. The signatories of the Treaty, “undertake to work jointly towards an economic policy that fosters the proper functioning of the economic and monetary union and economic growth through enhanced convergence and competitiveness”. Whilst the Treaty does not spell out how this will be done, Article 10 refers to a number of articles in the EU treaties, including Article 136, that permit eurozone countries to work together on “matters that are essential for the smooth functioning of the euro area, without undermining the internal market”.

There will be a “President of the Euro Summit”, to be elected by simple majority at the same time as the President of the European Council and for the same term of office, and they will hold eurozone summits at least twice a year in future at head of state or government level in addition to the regular eurogroup meetings of finance ministers. The Presidents of the Commission and of the ECB will be invited to attend the summits. The signatory countries of the Treaty who are not in the eurozone will “participate in discussions of Euro Summit meetings concerning competitiveness for the Contracting Parties, the modification of the global architecture of the euro area and the fundamental rules that will apply to it in the future, as well as, when appropriate and at least once a year, in discussions on specific issues of implementation of this Treaty” (Article 12 (3)).

Financial Stability

The European Stability Mechanism (ESM) – the permanent bailout mechanism for the eurozone replacing the temporary facilities created in the last two years – was established by a treaty signed by eurozone countries in July 2011. A new treaty was agreed separately to the Fiscal Compact Treaty on 30 January 2012. The intention is that the ESM will be brought into being in July 2012, a year earlier than planned.

The European Financial Stability Facility will continue to operate with existing programmes until mid-2013 with an overall ceiling for the two funds (currently €500 billion but to be reviewed in March 2012).

It is important to note that eurozone countries will not be able to receive help from these funds if they have not ratified the Fiscal Compact Treaty.

Issues in the Negotiations

The most significant issue was the relationship of this treaty to the EU treaties. The eurozone countries needed to make reference to the EU treaties as the entire legal basis of the eurozone lies in those treaties. This problem was addressed by including specific references to relevant articles of the EU treaties and by the general statement in Article 2 that the “provisions of this Treaty shall apply insofar as they are compatible with the Treaties on which the Union is founded and with European Union law”. This statement makes it clear that the provisions of the EU treaties override anything in the Fiscal Compact Treaty. The Treaty also states that nothing in it encroaches on the competence of the EU to act in the area of economic and monetary union.

A related issue was the use of the EU’s institutions, especially the Commission and the Court, under the Fiscal Compact Treaty. The UK Government had indicated in December that it

did not wish the EU institutions to be used for the purposes of the Treaty as the institutions of the EU were there for all Member States. In the event, the UK has effectively reserved its position after the final text of the Treaty made fewer references to the EU institutions than earlier drafts. The UK's position is that, as the Prime Minister put it to the House of Commons, "although some of those roles are permitted through existing treaties, there are legal questions about what is planned" but it will not take any action unless "our national interests are threatened by the misuse of the institutions".⁵

Part of the concern about the use of the institutions stemmed from a reference to "deeper integration in the internal market" in Article 1 of an early draft of the treaty being potentially to the detriment of the UK's position in the EU. This text originated in the December 9th statement but was dropped from the final treaty. The agreed text explicitly states in the preamble the desire of the contracting parties to use provisions in the EU treaties on co-operation between Member States "without undermining the internal market".

Next Steps & Future Developments

Each of the 25 countries that signed the Treaty in March 2012 now has to ratify it in accordance with its own constitutional procedures; it will enter into force on 1 January 2013 provided that 12 eurozone countries have completed ratification. Eurozone countries that have not ratified it by that date will be covered by its provisions from the first day of the following month after they have completed ratification. The Irish Government has announced that there will be a referendum in Ireland seeking approval of the treaty.

Other Member States of the EU can sign the Treaty and Article 16 states that within five years and on the basis of an assessment of the experience of its implementation, "the necessary steps shall be taken, in compliance with the provisions of the Treaty on the European Union and the Treaty on the Functioning of the European Union, with the aim of incorporating the substance of this Treaty into the legal framework of the European Union". Any such amendment of the EU treaties would of course require unanimous agreement among the Member States.

Since the draft treaty was agreed in January 2012, the markets have responded positively to the signs of greater co-operation amongst eurozone countries. But critics have questioned whether it does anything more than could have been done using existing EU treaties. Some of its defenders have accepted that its primary purpose was political rather than economic. It is certainly the case that there is no provision in the existing EU treaties, as the UK's Minister for Europe has observed, to make a balanced budget rule binding in a Member State's national law and to provide for automatic penalties if it is broken.

Bearing in mind the history of non-compliance with the terms of the Growth and Stability Pact, there must be some doubt as to whether, in the event, these stricter provisions will prove to be enforceable.

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⁵ The legal issues raised by the new treaty are considered in detail in House of Lords European Union Committee, *25th Report of Session 2010-2012: The euro area crisis*, HL 260, 14 February 2012, p. 28 *et seq.*



Senior European Experts

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