ARTICLES

A FISCAL COMPACT FOR A STRONGER ECONOMIC AND MONETARY UNION

This article reviews and assesses the key elements of the fiscal compact, which – as part of the new Treaty on Stability, Coordination and Governance in the Economic and Monetary Union – was signed by most EU Heads of State or Government on 2 March 2012. The United Kingdom and the Czech Republic abstained. The fiscal compact envisages the mandatory introduction of a balanced budget rule and an automatically triggered correction mechanism at the national level as well as a strengthening of the automaticity of the excessive deficit procedure within the Stability and Growth Pact in case a euro area country breaches the deficit criterion. Overall, the fiscal compact is a welcome step, since it addresses some of the remaining shortcomings of the reinforced EU fiscal governance framework which entered into force in December 2011. Nevertheless, national ownership, strict implementation and rigorous enforcement of the fiscal compact will be crucial. Looking ahead, ambitious further steps towards improving the EU fiscal framework will be necessary.

1 INTRODUCTION

The build-up of severe macroeconomic, financial and fiscal imbalances within the euro area, and the following sovereign debt crisis in several euro area countries called for a decisive reinforcement of the EU economic governance framework, in particular for the euro area, to ensure the stability and smooth functioning of EMU. EU and euro area leaders reacted in several incremental stages, inter alia, by introducing the European Semester[1], undertaking additional policy commitments in the Euro Plus Pact[2], and implementing six legislative changes to strengthen the EU economic governance framework (commonly referred to as the "six-pack", which entered into force in December 2011). The latter include the reform of both the preventive and corrective arms of the Stability and Growth Pact (SGP), the new minimum requirements for national budgetary frameworks, the new Macroeconomic Imbalance Procedure (MIP), and a stronger enforcement mechanism through new financial sanctions, under both the SGP and the MIP.[3] Moreover, the European Commission proposed in November 2011 two additional regulations to further strengthen surveillance of euro area countries (the "two-pack"), which will soon enter the trialogue negotiations between the EU Council, the European Commission and the European Parliament and which are expected to be finalised in the course of 2012. The first regulation is aimed in particular at giving new powers to the Commission to assess and, when necessary, request a revision of draft national budgetary plans as well as to ensure the correction of excessive deficits. The second regulation proposes new provisions allowing the Commission and the Council to step up the surveillance of the macroeconomic, financial and fiscal situation of euro area Member States experiencing or threatened with serious difficulties in terms of financial stability. The need for a reform of the governance framework has become more compelling in view of the mutating nature of the crisis – from a financial to a sovereign debt crisis.

Taken together, these legislative changes and policy decisions represent the most comprehensive set of governance reforms at the European level since the introduction of the single currency, leading to a substantial reinforcement of

1 The European Council agreed on 17 June 2010 to implement the European Semester as an instrument for the ex ante economic policy coordination from 1 January 2011. The European Semester comprises a timetable that applies to all elements of surveillance, including fiscal, macroeconomic and structural policies. The timing of the various surveillance processes is aligned to ensure consistency, while they remain legally and procedurally separate.

2 The Euro Plus Pact was agreed in March 2011 by the euro area Heads of State or Government and joined by Bulgaria, Denmark, Latvia, Lithuania, Poland, Romania to strengthen the economic pillar of EMU and to achieve a new quality of economic policy coordination, with the objective of improving competitiveness thereby leading to a higher degree of convergence.

3 See the article entitled "The reform of economic governance in the euro area – essential elements", *Monthly Bulletin*, ECB, March 2011.

Table 1 Treaty on Stability, Coordination and Governance: overview of main provisions

TSCG	Key elements
Title III: Fiscal compact	• Balanced budget rule including an automatic correction mechanism to be implemented in national law • Strengthening of the excessive deficit procedure • Enshrines the numerical benchmark for debt reduction for Member States with government debt exceeding 60% of GDP • Ex ante reporting on public debt issuance plans
Title IV: Economic policy coordination and convergence (see Box 1)	• Commitment to take additional policy actions fostering a smooth functioning of EMU and economic growth through enhanced convergence and competitiveness • Ex ante discussion and, where appropriate, coordination of major economic policy reforms to benchmark best practices
Title V: Governance of the euro area (see Box 2)	• Organisation of Euro Summit meetings at least twice per year • Conference of representatives of relevant committees of both the national parliaments and the European Parliament on the issues covered by the TSCG

Source: ECB.

the mutual surveillance framework. Nevertheless, concerns about the credibility of fiscal policies, the stability of the financial sector and the longer-term economic growth conditions in the euro area countries have remained, and market tensions in a number of countries continued against the background of high short-term refinancing needs. The fear of a spreading sovereign debt crisis, which could undermine the stability of the whole euro area, created the political willingness to support steps towards further strengthening the economic union to make it commensurate with monetary union.

To rise to this challenge, the euro area Heads of State or Government agreed on 26 October 2011 on a broad approach to address the sovereign debt crisis and to break the negative interaction with the stability of the financial sector.[4] In addition, on 9 December 2011 they laid down the contours of a new fiscal compact and a stronger coordination of economic policies, inviting the other EU Member States to join them, while also strengthening the stabilisation tools of the euro area.[5] On 2 March 2012, the Heads of State or Government of all EU Member States with the exception of the United Kingdom and the Czech Republic signed the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG), which includes the fiscal compact, a fostering of economic policy coordination and convergence as well as measures related to euro area governance (for a summary of the main elements see Table 1). As two Member States were not willing to commit to the TSCG, it takes the form of an intergovernmental agreement among contracting parties, which will enter into force after twelve euro area countries have ratified it.[6] However, the intention is to incorporate the substance of the TSCG into the EU Treaties within at most five years following its entry into force.[7]

This article offers a review of the TSCG, with the aim of assessing whether and how the fiscal compact can be expected to strengthen EU fiscal governance and national fiscal discipline. Moreover, the remaining key elements of the TSCG are presented in Boxes 1 and 2. Section 2 discusses why a stronger and stricter

4 See for details the Euro Summit statement of 26 October 2011, available on the European Council's website (http://www.consilium.europa.eu).

5 The statement by the euro area Heads of State or Government on 9 December 2011 also calls for a rapid examination and swift implementation of the two Commission proposals of November 2011 for further strengthening surveillance of euro area countries (the "two-pack"); see the European Council's website (http://www.consilium.europa.eu).

6 The TSCG also plays an important role for the European Stability Mechanism (ESM). As of 1 March 2013, the granting of financial assistance in the framework of new programmes under the ESM will be conditional on the ratification of the TSCG by the contracting party concerned and, as soon as the transposition period of at most one year has expired, on an adequate introduction of a number of key elements of the fiscal compact into national legislation.

7 The TSCG needs to respect the EU Treaties and must be applied and interpreted in conformity with EU law. For a discussion, see also the box entitled "Legal transposition of the TSCG" in this article.

fiscal framework is required to ensure a stable and smooth functioning EMU. Section 3 then describes the main elements of the fiscal compact, which are assessed against the background of the current EU fiscal framework in Section 4. Finally, Section 5 concludes.

2 WHY A STRONGER AND STRICTER FISCAL FRAMEWORK IS REQUIRED

Under the Treaty on the Functioning of the European Union (the Treaty), monetary policy is conducted at the supranational EU level, while fiscal, financial and structural policies have largely remained in the hands of the national governments. A price stability-oriented monetary policy alone is not sufficient for a proper functioning of EMU and needs to be accompanied by sound policies in other domains.[8]

For this reason, the Treaty and the SGP stipulate that euro area Member States have the obligation to avoid excessive government deficits (based on a deficit criterion and a debt criterion, which are assessed against the reference values of 3% and 60% of GDP respectively) and to "maintain sound and sustainable public finances". Moreover, the preventive arm of the SGP obliges Member States to maintain or to adjust towards their respective medium-term budgetary objective (MTO),[9] while the corrective arm of the SGP should ensure the correction of excessive deficits in case they still occur. The latter provides ultimately for financial sanctions for euro area countries in case of non-compliance with Council recommendations.[10]

However, the SGP did not succeed in securing fiscal discipline. Good economic times before the crisis were not used to achieve sustainable budgetary positions. Revenue windfalls were spent instead of being used to foster fiscal consolidation, violations of the deficit criterion were only slowly corrected and the debt criterion was largely ignored. The most important reason was that the SGP was only implemented half-heartedly as enforcement of the fiscal rules through peer pressure was weak. The procedures for addressing non-compliance lacked automaticity and thus left too much room for discretion. Financial sanctions have, in fact, never been imposed.

The lacking enforcement of the SGP was accompanied by only minimal differentiation in financial markets with respect to the interest rates on sovereign debt of euro area countries, resulting in only weak market discipline on fiscal policies in EMU. As a consequence, public finances of many euro area Member States were ill-prepared when the financial crisis erupted in the summer of 2007.[11] The following deep economic downturn, the working of automatic stabilisers, fiscal stimuli programmes and support for the financial sector led to a strong deterioration of public finances in many euro area Member States and ultimately to a sovereign debt crisis in some of them.

The sovereign debt crisis has demonstrated that unsustainable macroeconomic, financial and fiscal policies of any EMU member amplify each other and affect other euro area countries via negative spillover effects. This, in turn, endangers the financial stability of the euro area as a whole. As a consequence, the ECB repeatedly demanded a "quantum leap" in the EU economic governance framework to ensure the stability and smooth functioning of EMU.[12] Countries must recognise their joint

8 See the article entitled "One monetary policy and many fiscal policies: ensuring a smooth functioning of EMU", *Monthly Bulletin*, ECB, July 2008.

9 The aim of the MTO is threefold: (i) to preserve a safety margin with respect to the 3% of GDP reference value for the government deficit; (ii) to ensure rapid progress towards sustainable public finances and prudent debt levels; and thus (iii) to allow room for budgetary manoeuvre, in particular so as to accommodate public investment needs.

10 In 2005, a reform of the SGP introduced more discretion and flexibility into the surveillance procedures. This was strongly criticised by the ECB. See the article entitled "The reform of the Stability and Growth Pact", *Monthly Bulletin*, ECB, August 2005. For an in-depth discussion of the experience with the SGP, see the article entitled "Ten years of the Stability and Growth Pact" *Monthly Bulletin*, ECB, October 2008, and the references therein.

11 For details, see van Riet, A. (ed.) "Euro area fiscal policies and the crisis", *Occasional Paper Series*, No 109, ECB, Frankfurt am Main, April 2010.

12 See, for example, the article entitled "The reform of economic governance in the euro area – essential elements", op. cit.

responsibility for stability and prosperity in the euro area, which requires the setting-up of effective institutions.

In reaction to the sovereign debt crisis, EU and euro area leaders have strengthened the EU economic governance framework, in particular for the euro area Member States, inter alia through a reinforcement of the SGP within the so-called "six-pack". The entry into force of the new framework in December 2011 should improve economic and budgetary surveillance and enforcement. However, notably the following five key shortcomings in the EU fiscal framework remained.[13]

First, the large number of exceptional situations that can be taken into account weakens the application of the rules within the reinforced SGP. In particular, there is a long list of relevant – in most cases mitigating – factors to be considered when deciding whether a deficit or debt-to-GDP ratio is excessive. Consequently, non-compliance with the deficit or debt criterion will not necessarily result in an excessive deficit procedure being launched. Moreover, since the 2011 reform of the SGP, such relevant factors are even taken into account if the deficit substantially exceeds the 3% of GDP ceiling while the country's debt ratio is below the 60% of GDP reference value.

Second, the enhanced fiscal framework still lacks sufficient automaticity in case of non-compliance with the rules. In particular, the Council continues to have substantial room for discretion under the reinforced SGP. For example, the Council – on the basis of an overall assessment – has to decide by qualified majority that an excessive deficit exists.

Third, the effectiveness of the reinforced fiscal framework still depends heavily on a strict and rigorous application of the rules by the Commission. For example, the Commission plays a decisive role in the assessment of the existence of an excessive deficit or of whether Member States have taken effective action to correct an excessive deficit. Another example is that the Commission can give a recommendation to the Council to reduce or cancel the new financial sanctions, either on grounds of exceptional economic circumstances or following a request by the euro area Member State concerned.

Fourth, the reinforced fiscal governance framework is more complex, which might reduce its transparency as well as enforceability and, in turn, complicate accountability. In particular, the assessment of Member States' progress towards their respective MTOs requires a more complex analysis of both the structural budget balance and of expenditure net of discretionary revenue measures. In this context, it might be difficult to verify all the necessary data on time (e.g. with respect to detailed expenditure categories or the effects of discretionary revenue measures).

Finally, the agreed benchmarks for national budgetary frameworks are insufficient. Most notably, the strengthening of the national fiscal frameworks will largely depend on the countries' political will to implement sound fiscal rules.

3 KEY ELEMENTS OF THE FISCAL COMPACT

This section presents the key elements of the fiscal compact. The further provisions of the TSCG, covering economic policy coordination and convergence, as well as euro area governance, are presented in Boxes 1 and 2 at the end of the section. Some details of the legal implementation of the TSCG are addressed in Box 3.

The main goal of the fiscal compact is to foster fiscal discipline, notably in the euro area, building on and enhancing the reinforced SGP. It consists of two main modules: a balanced budget rule including an automatic correction mechanism, and a strengthening of the excessive deficit procedure. Under the first module, the contracting parties commit to implementing in their national legislation a fiscal rule which requires that general

13 See the box entitled "Stronger EU economic governance framework comes into force", *Monthly Bulletin*, ECB, December 2011.

government budgets are in balance or in surplus. This fiscal rule is deemed to be respected if the annual structural balance[14] is in line with the country-specific MTO – i.e. the MTO as defined in the preventive arm of the SGP – with a lower limit of a structural deficit of 0.5% of GDP. A higher structural deficit of at most 1% is only allowed if the government debt-to-GDP ratio is significantly below 60% and risks to long-term fiscal sustainability are low.

In line with the preventive arm of the reinforced SGP, progress towards and respect of the MTO must be evaluated on the basis of an overall assessment with the structural balance as a reference, including an analysis of expenditure net of discretionary revenue measures. The fiscal compact demands a "rapid convergence" to the MTO, while the time frame will be further specified in a proposal by the Commission, which should take country-specific sustainability risks into consideration.

Only when faced with exceptional circumstances may the contracting parties temporarily deviate from their MTO or the adjustment path towards it, provided that this does not endanger fiscal sustainability in the medium term. These exceptional circumstances refer to unusual events outside the control of the country concerned and with a major financial impact on the government budget, or to periods of severe economic downturn for the euro area or EU as a whole, as defined in the preventive arm of the reinforced SGP.

The balanced budget rule must include a correction mechanism, which is automatically triggered in the event of significant observed deviations from the MTO or the adjustment path towards it. This mechanism should aim at correcting such deviations, including their cumulated impact on government debt dynamics, and should also apply to temporary deviations justified by exceptional circumstances. The Commission has been given the task of proposing common principles for this correction mechanism.

The above-mentioned elements of the balanced budget rule must be introduced in the national law of the contracting parties within one year after the TSCG enters into force (see also Box 3). This must be done in a binding and permanent way, preferably at the constitutional level, or the rule must be otherwise guaranteed to be fully respected and adhered to in the national budgetary process.

The Commission has been invited to prepare a report on compliance with this transposition requirement. If the Commission concludes in its report that a contracting party has failed to comply, one or more of the other contracting parties will bring the matter before the European Court of Justice (the Court). Independently of such a Commission report, any contracting party can also call upon the Court to verify the transposition of the balanced budget rule and the correction mechanism into the national law. The Court's ruling is binding and the affected country must take the necessary measures to comply with the judgement within a specified period; otherwise, any other contracting party may bring the case again before the Court, which may then impose a lump sum or penalty payment of up to 0.1% of GDP. For euro area countries, the proceeds of such a fine will be transferred to the European Stability Mechanism (ESM) and for all other contracting parties to the EU budget.

As a further key element, the Commission is invited to publish common principles on the role and independence of the institutions responsible at the national level for monitoring compliance with all the provisions of the balanced budget rule.

The second module of the fiscal compact strengthens the excessive deficit procedure under the SGP, in particular by increasing its automaticity if a euro area country is in breach of the deficit criterion (see Section 4 for details). Another new element in this context is the requirement for countries that are subject to the excessive deficit procedure to submit budgetary

14 As in the SGP, the structural balance is defined in terms of the annual cyclically adjusted balance net of one-off and temporary measures.

and economic partnership programmes, including a detailed description of structural reforms, the aim being to ensure an effective and durable correction of the excessive deficit.

In addition, the fiscal compact covers the legal obligations of countries with high government debt and the risks associated with debt financing. In particular, the numerical benchmark for the reduction of government debt in excess of the reference value of 60% of GDP[15], as included in the corrective arm of the reinforced SGP, is now also enshrined in the fiscal compact. Furthermore, it requires ex ante reporting of public debt issuance plans to the Commission and the Council, which should allow for a better coordination of debt financing among contracting parties and in any case help to increase the transparency of governments' debt management strategies.[16]

Finally, the TSCG also includes provisions to strengthen economic policy coordination and to improve the transparency and accountability of euro area governance. These provisions are presented and assessed in Box 1 and Box 2.

15 Member States with debt-to-GDP ratios exceeding 60% must reduce the excess of their debt ratio over the reference value of 60% of GDP at an average rate of one-twentieth per year as a benchmark. However, this provision of the corrective arm of the reinforced SGP will only enter into force after a three-year transition period following the termination of the current country-specific excessive deficit procedure.

16 The content and modalities of this ex ante reporting must be specified by the Commission in cooperation with the Member States.

Box 1

ECONOMIC POLICY COORDINATION AND CONVERGENCE

In the institutional setting of Economic and Monetary Union economic policies have remained largely the competence of Member States. At the same time, national economic policies are regarded as a matter of common concern for the European Union and for the euro area in particular (Articles 120, 121 and 136 of the Treaty on the Functioning of the European Union (the Treaty)). This reflects the potential of national economic policies to affect other countries, especially in an economically closely integrated union of countries. In Title IV, the TSCG provides for some additional elements on economic policy coordination and convergence, which will be discussed below.

While the degree of economic policy coordination and its success in promoting growth and competitiveness has been rather limited so far[1], a number of important changes in the governance structure have been adopted in the context of the economic and financial crisis which should result in a significant strengthening of policy coordination. The crisis revealed that large macroeconomic imbalances could potentially endanger the economic and financial stability of the EMU, and the EU more generally. In response, a new EU macroeconomic surveillance framework, the Macroeconomic Imbalance Procedure, was set up and came into force in December 2011. This added a completely new element to the overall policy coordination framework, thereby filling an important gap. The Macroeconomic Imbalance Procedure aims at ensuring that Member States conduct their economic policies with a view to avoiding (under the preventive arm) or correcting (the corrective arm) excessive macroeconomic imbalances.

1 The main instruments of economic policy coordination that existed before the crisis were the integrated guidelines specified in the Lisbon Strategy, covering the broad economic policy guidelines (Article 121 of the Treaty) and the employment guidelines (Article 148 of the Treaty). Every year Member States submit their Stability or Convergence Programme (SCP) and their National Reform Programme (NRP), outlining the envisaged policy measures. In June 2010, the Europe 2020 Strategy replaced the Lisbon Strategy defining five headline targets for specific areas of economic policy (such as employment growth or investment in research and development). For more details on the available instruments for macroeconomic policy coordination, see also the article entitled "The reform of economic governance in the euro area – essential elements", *Monthly Bulletin*, ECB, March 2011.

The new procedure also uses a number of features that should support its effectiveness, such as reverse qualified majority voting and the possibility of imposing financial sanctions on euro area countries in the case of non-compliance. In a further effort to strengthen economic governance, Heads of State or Government of euro area countries and a number of other EU countries agreed in March 2011 on the Euro Plus Pact, a non-binding policy coordination framework setting targets for, inter alia, improving competitiveness and fostering employment.

The TSCG provides some additional elements to the policy coordination framework. First, the contracting parties underline their commitment to work towards an economic policy that fosters the smooth functioning of EMU and to achieve economic growth through enhanced convergence and competitiveness. Second, they commit to closer economic policy coordination "where appropriate and necessary" through (i) stronger coordination and surveillance of budgetary discipline among euro area countries and the adoption of specific euro area economic policy guidelines, as well as (ii) the use of enhanced cooperation, which allows a sub-set of EU countries to cooperate more closely when not all EU Member States are willing to do so. Third, the TSCG stipulates that all major economic policy reforms planned by contracting parties will be discussed ex ante and, where appropriate, coordinated with a view to benchmarking best practices.

Overall, the TSCG reconfirms that economic policies remain largely the competence of Member States, while adding only broadly formulated commitments for greater policy coordination, focused on promoting convergence and competitiveness. Although these commitments are welcome, they lack specificity, setting no concrete targets, structural measures to be taken, or timelines. Notably, apart from a reference in a recital, the TSCG fails to mention the Euro Plus Pact explicitly and does not make it a binding instrument. Rather, it only mentions, in general terms, the four objectives of the pact[2], without providing for their legal enforceability.

Furthermore, the TSCG does not specify any new instruments, or a further strengthening of existing instruments enabling the EU to instruct countries to implement specific reforms should they endanger the smooth functioning of EMU. Consequently, contracting parties must make full use of and build on the existing instruments as already defined in the EU Treaties to implement the necessary reforms.

In order to improve the structural characteristics of the economies of euro area Members States, economic policy coordination must be geared towards benchmarking national policies against international best practices. In particular, ex ante discussion and, where appropriate, coordination of economic reforms should allow euro area member countries to move ahead with ambitious reform projects, while providing sufficient peer support to those who are lagging behind. However, for cases where failure to implement urgent reforms has the potential to affect other countries, it should be made possible to instruct the country concerned to undertake the necessary steps. Further steps in this direction would be most welcome.

Among the most urgent reform projects for most Member States are the removal of rigidities in product and labour markets. As the ECB has pointed out on several occasions[3], these rigidities

2 These four objectives are to 1) foster competitiveness, 2) promote employment, 3) make public finances sustainable and 4) reinforce financial stability.

3 See, for example, the box entitled "The 2008 update of the integrated policy guidelines of the Lisbon Strategy", *Monthly Bulletin*, ECB, April 2008 (and previous assessments published in the *Monthly Bulletin* in April 2007 and January 2006), the box entitled "Structural policy priorities for the euro area", *Monthly Bulletin*, ECB, April 2009, or the article entitled "Labour market adjustments to the recession in the euro area", *Monthly Bulletin*, ECB, July 2010.

create significant risks to the smooth functioning of EMU. To remedy this, barriers to competition in product markets have to be removed by opening closed professions, easing the entry for new firms (removing red tape) and strengthening competition authorities. Notably liberalisation in service sectors is necessary to increase competition and facilitate the necessary adjustments in relative prices in countries that have lost competitiveness. In this respect, the full implementation of the Services Directive will further support the integration of services markets and, in turn, improve competition.

In addition, the flexibility of labour markets needs to be enhanced, given the high level of unemployment in many Member States. Wage flexibility will particularly allow the appropriate degree of wage differentiation across different types of workers and stimulate the hiring of young, female and older workers. Rigidities in labour markets need to be addressed by reducing the degree of employment protection for permanent jobs. Other labour market reforms that should be pursued in order to alleviate bottlenecks and foster flexibility include the reduction of minimum wages, the elimination of wage indexation mechanisms and the strengthening of firm level agreements so that wages and working conditions can be tailored to firms' specific needs.

Governments urgently need to strengthen efforts to implement structural reforms to regain competitiveness, and most importantly, correct existing macroeconomic imbalances. The latter is essential to reduce the vulnerability of these economies and of the euro area as a whole. Enhancing competitiveness fosters higher productivity and potential growth, which in turn will facilitate fiscal sustainability. At the same time, reforms aimed at improving competition will also contribute to lowering price pressure.[4]

4 Recent empirical evidence confirms that rigidities in labour and product markets tend to increase the persistence of inflation. In addition, commodity price shocks are more likely to result in higher wages when the wage setting is not at firm level (see, for instance, Jaumotte, F. and Morsy, H., "Determinants of Inflation in the Euro Area: the Role of Labour and Product Market Institutions", *IMF Working Paper*, WP/12/37, IMF, January 2012).

Box 2

GOVERNANCE OF THE EURO AREA

The improvement of governance in the euro area is an important element of the Treaty on Stability, Coordination and Governance (TSCG), reflected in particular in Title V (Governance of the euro area). The TSCG mainly provides for a strengthening of Euro Summits as a forum for regular coordination as well as a strengthening of the role for the European and national parliaments. This box discusses these aspects in more detail.

The TSCG foresees, as a minimum, two meetings per year of the Heads of State or Government of euro area Member States in Euro Summits to discuss specific questions related to euro area membership. The TSCG contains a range of detailed provisions regarding the organisation of and participation in the meetings. In particular, Euro Summits will be prepared by the President of the Euro Summit (to be appointed by the euro area Heads of State or Government), in close cooperation with the President of the Commission and the Eurogroup. The President of the ECB will also be invited to the meetings. The President of the Euro Summit will keep the non-euro area Member States closely informed of the preparations for and the outcome of the Euro Summits.

The formal recognition of Euro Summits is helpful for three reasons. First, it helps to support ownership and responsibility for the smooth functioning of the euro area at the highest political level. Discussing explicitly the specific responsibilities attached to euro area membership supports the internalisation of possible spillover effects on the rest of the euro area and the EU when formulating domestic policies. Second, given the broad remit of the Heads of State or Government, the political orientations agreed upon at Euro Summits can include policy areas beyond the scope of finance ministers, which facilitates coordination of all relevant policy areas and instruments (e.g. in the field of competitiveness) that are necessary for the smooth functioning of EMU. In this way, the Euro Summits can provide strong guidance in various areas, thus compensating partly for the lack of hard constraints on economic polices (in the field of labour market reforms, for example). Finally, Euro Summits will ensure that any risks to the smooth functioning of EMU as well as economic policy and governance issues will figure regularly on the agenda of the euro area decision-makers at the highest political level. However, this new coordination mechanism through Euro Summits remains in essence a voluntary exercise. Moreover, the success of Euro Summits will also depend on their sound preparation by the subordinate political and technical bodies.

To ensure a proper degree of transparency and accountability, the TSCG foresees a role for the European Parliament and national parliaments in its implementation. The President of the European Parliament may be invited to the Euro Summits, whose President must in turn report to the European Parliament on the outcome of summit meetings. Moreover, the TSCG also refers explicitly to the possibility of the relevant committees of the European Parliament and of national parliaments to discuss together budgetary policies and other issues covered by the TSCG.

The various Euro Summits in 2011 have also taken additional decisions to strengthen euro area governance. These elements, which are not taken up in the TSCG, include (i) enhancing the decision-making capabilities of the euro area, notably by permanently strengthening its preparatory substructures and electing a full-time, Brussels-based chair of the Eurogroup Working Group, as well as (ii) regular monthly meetings between the Presidents of the Euro Summit, the Commission and the Eurogroup.[1]

From an ECB perspective, it is important to ensure that the new governance framework is implemented rigorously. The enhanced decision-making capacity of the euro area and new surveillance instruments must be used to the greatest extent to put national macroeconomic, financial and fiscal policies on a sustainable path, with a view to avoiding the emergence of potentially destabilising imbalances and adverse spillover effects. It is important that all those involved, the Commission, the Eurogroup, the Council and the Euro Summit in particular, exert the necessary peer pressure on countries which are threatening the stability of the euro area as a whole.

1 See Annex 1 of the Euro Summit statement of 26 October 2011 (“Ten measures to improve the governance of the euro area”).

4 ASSESSMENT OF THE FISCAL COMPACT

Can the fiscal compact be expected to achieve its main goals, namely to foster fiscal discipline and to enhance the reinforced SGP? To allow for a proper assessment, the key elements of the fiscal compact are compared to the EU regulations of the preventive arm (a) and the corrective arm of the reinforced SGP (b).

a) Fiscal compact vis-à-vis the preventive arm of the reinforced Stability and Growth Pact

The general provisions of the balanced budget rule in the fiscal compact are largely concordant with the EU regulations of the preventive arm of the SGP. In fact, the fiscal compact explicitly refers to it in the following three areas (see Table 2): the MTO, the escape clause and the assessment of compliance with the adjustment path.

First, the balanced budget rule refers explicitly to the MTO of the SGP, which requires the general government budget to be close to balance or in surplus in structural terms and sets a structural deficit limit of 1% of GDP for euro area and ERM II countries. The fiscal compact sets a lower general limit of a structural deficit of 0.5% of GDP, while the limit can be increased to up to 1% only for countries with a government debt-to-GDP ratio significantly below 60% and with low risks to long-term fiscal sustainability. However, in practice the new balanced budget rule will not be more ambitious than the EU regulation already demands, since all euro area countries currently have an MTO that equals a structural deficit of 0.5% of GDP or less.

Second, the definition of the escape clause in terms of exceptional circumstances is the same in the fiscal compact as in the preventive arm of the SGP. In addition, the detailed provisions of the latter also allow, under strict conditions, for larger deviations from the MTO or the adjustment path towards it in case of major structural reforms or pension reforms that benefit fiscal sustainability in the longer term.

Third, whether observed deviations from the balanced budget target or the convergence path towards it are considered significant will be evaluated on the basis of an overall assessment with the structural balance as a reference, including an analysis of expenditure net of discretionary revenue measures, thereby following the provisions of the reinforced SGP.[17]

Compared with the preventive arm of the SGP, however, the fiscal compact offers four main improvements, provided they are strictly implemented and rigorously enforced.

First, from a legal perspective, it brings key elements of the SGP (EU secondary law) into an intergovernmental treaty, which requires the introduction of such key elements into the constitutions of contracting parties (or at least into legal acts of close-to-constitutional nature; see Box 3). Furthermore, the new conference of representatives of relevant committees of both the national parliaments and the European Parliament on the issues covered by the TSCG, including the fiscal compact, contributes to democratic accountability. These two aspects may increase national ownership, imply a firmer national anchoring of fiscal discipline and thereby create a stronger commitment to sound fiscal rules.

A second enhancement is that the fiscal compact should facilitate a more rapid convergence towards the country-specific MTOs, especially when due consideration is given to country-specific risks to fiscal sustainability, which in the aftermath of the financial crisis have risen substantially for many euro area countries. This requires that the Commission proposes ambitious and binding calendars of convergence, which go beyond the requirements of the reinforced SGP. A rapid convergence to MTOs can help to regain trust in the fiscal sustainability of EMU countries and restore the credibility of their fiscal policies.

Third, the fiscal compact provides for an automatically triggered correction mechanism, which will be based on common principles to be proposed by the Commission. In this context, it is essential that the Commission elaborates sufficiently well-specified, strict and binding requirements for the envisaged correction mechanism and its implementation in national law. Given the past experience of insufficiently declining or even rising government debt ratios, it is of utmost importance that, as foreseen in the fiscal compact, the mechanism fully corrects the cumulative impact on government debt of past

17 The code of conduct of the SGP (from 24 January 2012) foresees that significant deviations require at least a breach of one criterion and limited compliance with the other (see Table 2). This could mean that deviations of the structural budget balance from the MTO or the adjustment path towards it alone are not sufficient for a significant deviation if the country still complies with the expenditure criterion.

Table 2 Comparison of the preventive arm of the reinforced Stability and Growth Pact with the balanced budget rule of the fiscal compact

	Reinforced Stability and Growth Pact (preventive arm)	Fiscal compact (balanced budget rule)
Legal basis	• Secondary EU law	• Primary law (intergovernmental and national level)
Budgetary objective	• Close to balance or in surplus • Country-specific MTO: maximal structural deficit of 1% of GDP for euro area countries	• Balanced or in surplus • Country-specific MTO: maximal structural deficit of 0.5% of GDP (or at most 1% if debt-to-GDP ratio is below 60% and long-term risks to fiscal sustainability are low)
Escape clauses	• Severe economic downturn in euro area or EU as a whole • Unusual event outside the control of the government with major financial impact • Implementation of structural and/or pension reforms (under strict conditions)	• Replicates reinforced SGP (without explicit reference to structural and/or pension reforms)
Convergence to budgetary objective	• Assessed on the basis of the structural balance and expenditure rule • Benchmark: annual improvement of structural balance of 0.5% of GDP (higher in economic good times and/or if debt-to-GDP ratio exceeds 60% or if there are pronounced risks to the sustainability of overall debt; might be lower in bad economic times)	• Rapid convergence to MTO (details to be proposed by the Commission) taking sustainability risks into consideration • Evaluation of progress as in the reinforced SGP
Assessing compliance	• Significant observed deviation (for a Member State that has not reached its MTO) in case of simultaneous breach of the two following criteria (or breach of one and limited compliance with the other): – Structural deficit criterion: exceeding adjustment path to MTO by at least 0.5% in one or 0.25% on average in two consecutive years – Expenditure criterion: negative impact of expenditure developments (net of discretionary revenue measures) on adjustment path of government balance of at least 0.5% of GDP in one or cumulatively in two consecutive years	• Assessment of "significant observed deviations from the MTO or the adjustment path towards it" follows the reinforced SGP • Common principles on the role and independence of national monitoring institutions to be proposed by the Commission
Correction mechanism	• In case of a significant observed deviation from the adjustment path towards the MTO: warning by European Commission • Council recommendation for the necessary policy measures on the basis of a Commission recommendation (deadline of not more than 5 months (3 months in particularly serious cases) for addressing the deviation)	• To be triggered automatically in the event of significant observed deviations from the MTO or its adjustment path (including obligation to implement measures to correct the deviations over a defined period of time) • Implemented at the national level on the basis of common principles to be proposed by the Commission that concern, in particular, the nature, size and time frame of the corrective action to be undertaken also in the case of exceptional circumstances • Correction should include the cumulated impact of past deviations on government debt dynamics
Enforcement	• Commission can propose financial sanction (interest-bearing deposit of 0.2% of GDP) if no effective action has been taken • Automatic approval (of the sanction) – unless the Council rejects the Commission recommendation by qualified majority of euro area Member States excluding the country concerned	• In addition to the reinforced SGP, financial sanctions can be imposed by the European Court of Justice if the balanced budget rule and the correction mechanism are not properly implemented in national law

Source: ECB.

observed deviations from the MTO (including those justified by the escape clause) in a timely manner. Moreover, the corrective measures to be implemented by contracting parties over a defined period of time must be triggered automatically. This should reduce the incentives and possibilities to postpone fiscal consolidation to later periods. Such an automatic correction mechanism should effectively amount to a "debt brake" and contribute to preventing and correcting unsustainable public finances. In addition, it would constitute an important improvement compared to the preventive arm of the SGP, which aims at correcting significant deviations from the MTO or the adjustment path towards it, but does not foresee the correction of debt increases due to past budgetary slippages.[18]

The fourth enhancement offered by the fiscal compact is the possibility to call upon the European Court of Justice to verify the transposition of the balanced budget rule and the automatic correction mechanism into national law – including the possibility of financial sanctions to be imposed by the Court. The role of the Commission in this respect is limited to preparing a report that a contracting party may have introduced this balanced budget rule into its national law in a deficient way, or not at all, as only the other contracting parties can ask the Court to verify this transposition. In this context, it will be essential that the concrete procedures are clear and well-specified to ensure that a deficient introduction is brought before the Court. Monitoring actual observance of the balanced budget rule will not involve the Court. This responsibility is left to national institutions with a certain degree of independence, in addition, of course, to the whole budgetary surveillance mechanism of the SGP and other EU legislation.

b) Fiscal compact vis-à-vis the corrective arm of the reinforced Stability and Growth Pact

The fiscal compact leads to more automaticity in the procedures of the corrective arm of the SGP following a breach of the deficit criterion by a euro area country. In this case, contracting parties whose currency is the euro commit to supporting the Commission's proposals or recommendations for Council decisions in the framework of an excessive deficit procedure, unless a qualified majority of them (without the Member State concerned) is opposed to such a decision (see Figure). The introduction of this voting commitment by euro area countries for important procedural steps, such as the opening of an excessive deficit procedure, the decision whether a euro area Member State has taken effective action, and a possible stepping-up of the excessive deficit procedure, increases the automaticity of procedures compared to the reinforced SGP. This implies, for instance, that if the Commission were to conclude after a euro area country breaches the deficit criterion that an excessive deficit exists and addresses a corresponding opinion to the Member State concerned and a proposal to the Council, the proposal will pass unless a qualified majority among the euro area members of the Council decides to oppose it.[19]

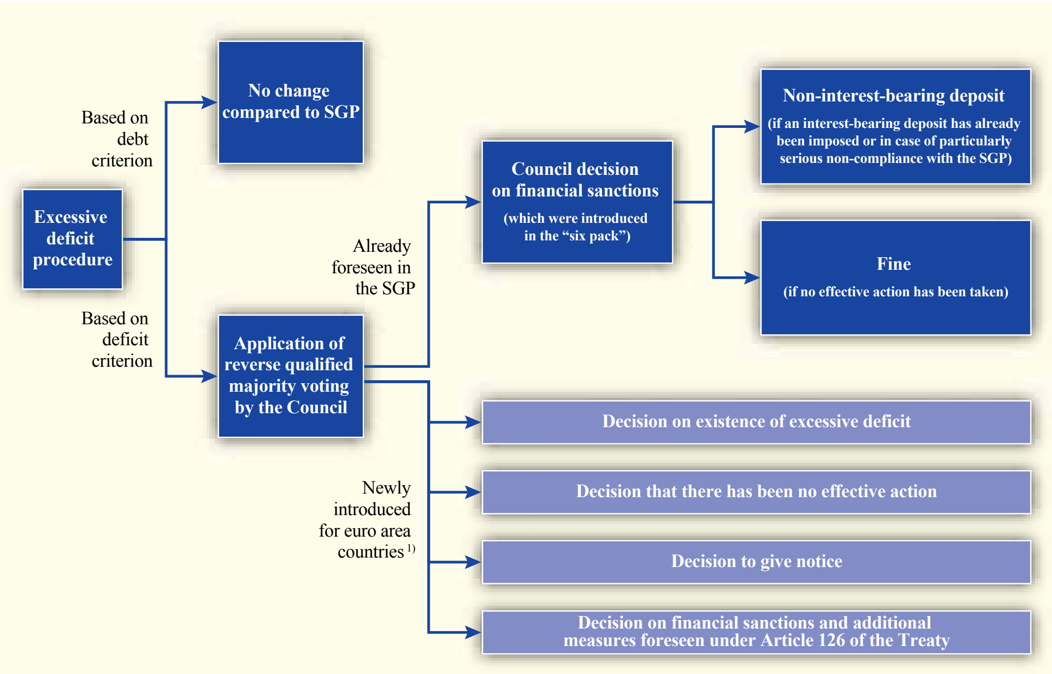
One notable source of weakness of the fiscal compact is, however, that such reverse qualified majority voting will not be applied following a breach of the debt criterion by a euro area country. In these cases, the decision procedure as laid down in Article 126 of the Treaty will continue to apply, i.e. adoption by a qualified majority of euro area Member States, excluding the country concerned. Moreover, the excessive deficit procedure for non-euro area Member States is not affected at all.

Overall, the higher degree of automaticity introduced by the fiscal compact for euro area countries that breach the deficit criterion appears to be a step in the right direction, since it reduces the leeway for political discretion in the framework of the excessive deficit procedure and makes a strict application of the rules and the application of sanctions more likely. This repairs (although only partly) an important shortcoming in the corrective arm of the SGP and strengthens, in turn, the incentives for sound fiscal policies.

18 One could argue that for countries with government debt above 60% of GDP, the numerical benchmark of a reduction of the excess of their debt ratio over this reference value at an average rate of one-twentieth per year as a benchmark is one attempt to ensure the correction of past budgetary slippages.

19 Note that since the entry into force of the Lisbon Treaty on 1 December 2009, only Member States whose currency is the euro have the right to vote in the Council concerning measures related to excessive deficits of euro area members.

Comparison of the corrective arm of the reinforced Stability and Growth Pact with the fiscal compact



Source: ECB.
Notes: Under the reinforced SGP an excessive deficit procedure can be initiated on the basis of a breach of the deficit criterion and/or a breach of the debt criterion. The fiscal compact strengthens the decision-making procedure of the excessive deficit procedure following a breach of the deficit criterion by a euro area country, but not that in case of a breach of the debt criterion. In particular, the fiscal compact provides for the application of reverse qualified majority voting by the euro area countries on important steps in the excessive deficit procedure (marked in lighter blue), for which Article 126 of the Treaty demands qualified majority voting. This increases the automaticity of the excessive deficit procedure following a breach of the deficit criterion. If a Member State repeatedly fails to comply with a decision by the Council, the Council may apply additional measures under Article 126 of the Treaty. The Council may, for example, require the Member State concerned to publish additional information or to invite the European Investment Bank to reconsider its lending policy towards that Member State.
1) According to Article 7 TSCG, the contracting parties whose currency is the euro commit to supporting the proposals or recommendations submitted by the European Commission.

However, the improvement is generally dependent on a strict implementation of the commitments of the euro area contracting parties to vote in favour of the proposals and recommendations of the Commission in the context of the excessive deficit procedure following a breach of the deficit criterion unless a qualified majority of them is opposed. Furthermore, it is crucial that the Commission uses its increased influence under the excessive deficit procedure by taking a rigorous approach when assessing fiscal deficits and avoids politically influenced decisions. In this respect, the recent upgrade of the Commissioner for Economic and Financial Affairs to Vice-President of the Commission and Commissioner for the Euro, and the greater autonomy he has been granted in taking surveillance decisions, might contribute to more independent and rigorous assessments.

Box 3

LEGAL TRANSPOSITION OF THE TREATY ON STABILITY, COORDINATION AND GOVERNANCE

The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG) has been signed by 25 of the 27 Member States and thus has the form of an intergovernmental treaty outside the EU legal framework. This box discusses some issues regarding its relation with national law and EU law, focusing on the legal implementation of the fiscal compact.

As regards the relation with national law, the Member States that have ratified the TSCG will be obliged to introduce into their national legislation a number of key elements of the fiscal compact, which will have a direct impact on their fiscal policies. The preferred national law into which these elements will need to be introduced is the constitution. Under circumstances, a different law than the constitution could be used, provided that it is of a higher nature than the legislation which approves the yearly national budget. The annual budget law and the process to prepare the budget will thus be subject to the legislation containing the different elements to be included by the contracting parties in their national legislation, such as the balanced budget rule and the automatic correction mechanism, in a similar manner as they would be subject to the constitution. The Court of Justice of the European Union is given jurisdiction to adjudicate on the correct introduction of the fiscal compact, which has to be introduced into national law by the Member States following a report by the Commission.

Most of the key elements of the fiscal compact to be introduced into national law are fully contained in the TSCG, namely the details of the balanced budget rule to be observed and the allowance for exceptional circumstances. Hence, for these two elements no development in secondary EU law or other action by the Commission is necessary in order for the national legislator to bring them into national law. Regarding the obligation of Member States to ensure rapid convergence towards their respective medium-term objective (MTO) which the TSCG explicitly introduces, the TSCG lays down that the time frame for such rapid convergence will be proposed by the Commission.

For the automatic correction mechanism that comes into force in case of deviations from the balanced budget rule, the TSCG provides for a necessary step before the national legislator can act, since the TSCG requires that the Commission will lay down common principles on the basis of which the Member States must introduce the correction mechanism into their legislation.

The text of the TSCG has already indicated to the Commission a list of aspects which the common principles will need to cover in any case, in addition to other aspects that the Commission might include itself. According to this list, the common principles will deal, inter alia, with the nature, size and timing of the necessary corrective measures in case of deviations from the balanced budget rule, including the corrective action to be taken in case of deviations due to exceptional circumstances. The correction of the cumulated impact of the deviations on government debt dynamics will also need to be covered by the mechanism, as recalled by the recitals of the TSCG. The common principles will also need to cover the role and independence of the institutions responsible at national level for monitoring the observance of the balanced budget rule. As expressly established in the TSCG, this correction mechanism must fully respect the prerogatives of national parliaments.

As regards the relation with EU law, the TSCG must be applied and interpreted in conformity with the treaties on which the EU is founded and with EU law, including procedural law for the adoption of secondary EU legislation. This is an obvious consequence of the mandatory character of EU law. The TSCG can be complemented by secondary EU legislation and it indeed makes reference to such legislation in the recitals, in particular regarding (i) the modalities of the ex ante reporting of public debt issuance plans, (ii) the scope of the economic partnership programmes detailing structural reforms for Member States in the excessive deficit procedure, as well as (iii) the coordination of major economic policy reform plans of Member States.

The TSCG will enter into force after ratification by at least 12 euro area countries. It will apply to all Member States which ratify it, i.e. to euro area and non-euro area Member States. However, at a first stage at least, some of the EU secondary legislation complementing the TSCG will be based on Article 136 of the Treaty and will therefore only apply to the contracting parties whose currency is the euro. This is why, at a later stage, the necessary EU legislation covering the whole EU will need to be put in place. In the meantime, nothing precludes non-euro area Member States from voluntarily applying it through national legislation. In addition, it is worth noting that the TSCG itself has the explicit aim of having its substance incorporated into the EU legal framework within at most five years following its entry into force, on the basis of the experience gained.

5 CONCLUSIONS

Following the entry into force of the strengthened EU economic governance framework in December 2011, the agreement on the TSCG, and the fiscal compact in particular, constitutes a welcome step towards a stronger rule-based fiscal governance framework. The mandatory implementation of the balanced budget rule and the automatically triggered correction mechanism at the national level should increase the national commitment to sound and sustainable public finances. If strictly implemented and rigorously enforced, this should help to effectively prevent unsustainable fiscal policies, complementing the rules of the SGP.

In this context, it is crucial that the automatic correction mechanism, whose common principles will be elaborated by the Commission, ensures an effective correction of the cumulated past budgetary slippages, as foreseen in the fiscal compact. Moreover, the Commission needs to propose calendars for rapid convergence to the country-specific MTOs, which go beyond the current requirements of the SGP, taking account of country-specific sustainability risks. Furthermore, the Commission plays a vital role in reporting on the proper transposition of the balanced budget rule into the national law of contracting parties and in proposing common principles on the role and independence of their monitoring institutions.

At the national level, broad ownership is needed, i.e. parliaments, governments and monitoring institutions must live up to the spirit of the TSCG and ensure full compliance with the balanced budget rule. This is vital to anchor fiscal discipline and market expectations of the sustainability of public finances in Europe, which in turn will foster medium-term growth.

At the EU level, the higher degree of automaticity in the excessive deficit procedure of the SGP should help to ensure a rigorous enforcement of the deficit limit for euro area countries.

Although the fiscal compact addresses some of the remaining shortcomings of the existing fiscal governance framework, its effectiveness and credibility remains subject to a strict implementation of fiscal policy surveillance by the Commission and a limited use of political discretion by the Council. Finally, the complexity of the overall fiscal framework has not been reduced, since the fiscal compact basically adds an additional layer to the existing rules of the SGP.

Looking further ahead, ambitious steps towards improving the EU fiscal framework, in particular for euro area countries, will be necessary to address the remaining shortcomings. A general vulnerability of the existing framework is that it lacks instruments for situations in which a country's fiscal policy, despite strict surveillance, enforcement and correction mechanisms, continues to go harmfully astray. This could be tackled by giving European institutions the competence to effectively compel euro area Member States – in a graduated manner as the situation deteriorates – to take the necessary fiscal policy decisions. That should help to provide credible incentives for sound fiscal policies.