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COMMUNICATION FROM THE COMMISSION

The Fiscal Compact: Taking Stock

1. INTRODUCTION

The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG) was formally concluded on 2 March 2012 and entered into force on 1 January 2013. The main provision of this Treaty is the requirement to have a balanced budget rule in domestic legal orders (the Fiscal Compact). Out of the 25 Contracting Parties to the TSCG, 22 are formally bound by the Fiscal Compact (the 19 euro area Member States plus Bulgaria, Denmark and Romania). The Treaty invited the Commission to report on the measures adopted by these Contracting Parties in that regard (Article 8 TSCG). After extensive exchanges with the Contracting Parties, the Commission Report issued alongside this Communication presents the conclusions from that analysis.

2. THE FISCAL COMPACT: ORIGINS AND EXPECTATIONS

The financial and economic crisis that erupted a decade ago marked the start of a deep review of the economic governance arrangements for the EU and the euro area. An early response came in the form of the so-called 'Six-Pack' (five Regulations and a Directive), the main purpose of which was to strengthen the preventive safeguards against the build-up of fiscal and macroeconomic imbalances sowing the seeds of future crises. Those provisions were accompanied by the creation of common instruments of financial assistance to support countries in the euro area that had accumulated large imbalances and banking problems and had come under severe market pressures.

As the financial crisis persisted and the market pressure on more vulnerable Member States continued to intensify in the early 2010s, it became clear that a more profound response was called for. That response involved stronger commitments from Member States and more powerful joint instruments.

In particular, it was felt that the EU rules-based fiscal framework (the Stability and Growth Pact (SGP)) should be complemented by provisions at the national level in order to better achieve sound budgetary policies in all Member States. Specifically, new domestic legislation would commit Member States to enshrine the objectives of a balanced budget within their national legal framework and thus act as a lasting mechanism against the emergence of excessive deficits.

In that context, an amendment to the Treaty on the Functioning of the European Union (TFEU) was explored to allow Union law to underpin such national rules. However, when meeting in December 2011, the European Council failed to agree on such amendment. In reaction, the Member States that wanted to jointly commit to having such domestic rules agreed to proceed on an intergovernmental basis, under which each Contracting Party would enshrine in its own national legal order a balanced budget rule of binding character, together with supporting monitoring and correction mechanisms. The result was the TSCG.

The Fiscal Compact *per se* is only one part of the TSCG (Title III). Within the Fiscal Compact, Article 3 requires a balanced budget rule in national legislation. Other provisions in the Fiscal Compact aim notably at strengthening the excessive deficit procedure (EDP). Outside the Fiscal Compact, other parts of the TSCG reinforce economic policy coordination and the governance of the euro area.

The TSCG was part of a broader policy response to the euro area crisis. In particular the TSCG was politically tied to the provision and extension of financial firewalls in the form of the European Financial Stability Facility and the European Stability Mechanism (ESM), which was adopted as a permanent facility in 2012. A recital to the ESM Treaty makes the

granting to any Contracting Party of financial assistance subject to TSCG ratification by it and compliance with the requirements set out in Article 3 TSCG and a recital to the TSCG stresses the importance of setting up the ESM. The Union took other crucial steps at around the same time, including in particular reduction of risk through the first steps of the Banking Union.

The Union legislator deepened budgetary surveillance and coordination in the euro area further in 2013, by adopting the so-called 'Two-Pack'. Amongst other things, those two Regulations integrate some of the elements of the Fiscal Compact into Union law, including in particular the existence of independent bodies monitoring compliance with national fiscal rules, as well as the requirement for Member States in EDP to prepare economic partnership programmes and the requirement for ex-ante coordination of Member States' debt issuance plans. Earlier on, the directive on requirements for budgetary frameworks that was part of the Six-Pack had already set minimum characteristics for national fiscal frameworks.

The TSCG is an intergovernmental Treaty and it is not part of the Union legal order. In 2011 the Commission underlined that it would have been preferable to rely instead on the Union legal framework, but to deal with a crisis situation it went along with the intergovernmental approach as an emergency stopgap. Moreover, the TSCG included safeguards to ensure consistency with Union law. First, the TSCG must be applied and interpreted in conformity with the EU Treaties. Second, the substantive balanced budget rule of the Fiscal Compact in large part replicates the medium-term objective of the SGP, while some other parts of the TSCG mirror substantive rules now in place in Union law. Third, the TSCG includes an incorporation clause into Union law within five years from its entry into force (that is, by 1 January 2018).

3. MAIN FINDINGS OF THE REPORT

The conclusions are based on a thorough examination of the relevant national provisions as well as extensive consultation of Contracting Parties. Article 8 TSCG empowers the Contracting Parties to take legal action in case of non-compliance, should they consider it necessary, which they may also do independently from the Report of the Commission.

The Contracting Parties had to introduce in their domestic legal order by 1 January 2014 the necessary implementing provisions. After that deadline passed, the Commission services asked about those national provisions, in particular *via* 'pilot letters' sent to Contracting Parties in July 2015. The Commission subsequently requested, in May 2016, formal observations from Contracting Parties where potential compliance issues had been identified.

The conclusions of the Report incorporate the clarifications and action commitments taken or announced by Contracting Parties in response to the Commission's enquiries. In line with the mandate conferred on it by the TSCG, the Commission has scrutinised the legal conformity of the provisions. Analysing their practical application is outside the scope of the Commission Report.

All Contracting Parties have significantly adapted their national fiscal frameworks as a result of the Fiscal Compact requirements, in conjunction with Union legislation.

As presented in the Commission Report, they have all put in place binding and permanent balanced budget rules in their domestic legal orders. For some those changes involved constitutional amendments, while others adopted alternative forms of binding frameworks. In line with the TSCG requirements as further specified in common principles set out by the Commission, those national rules are backed by correction mechanisms triggered

automatically in the event of significant observed deviations as well as by independent national fiscal institutions with an adequate monitoring mandate. In that way, independent bodies have been created or meaningfully strengthened, with the capacity to play an increasing role in national public debates on fiscal policy.

Given the diversity in national budgetary settings, the Report finds a significant degree of heterogeneity in the national provisions adopted by the Contracting Parties. That finding is not surprising. The framework set by the TSCG and the accompanying common principles is one of relatively broad requirements that are principles-based, reflecting compromises needed when negotiating the TSCG and the common principles. In addition, to raise national ownership, margin was given to customise national provisions to the specific institutional budgetary setting of each Contracting Party. Contracting Parties have accordingly exploited the scope offered by the TSCG when devising their national provisions while respecting its core requirements. That feature is seen in, for example, distinct approaches to flexibility within the correction mechanisms as well as in varying ambitions, beyond the minimum requirements, in the setting and mandate of national independent monitoring institutions. Another emerging difference of approach concerns the scope given to specific national rules and procedures – some Contracting Parties have developed their own provisions while others give increased emphasis to consistency with the SGP and so rely on decisions from Union institutions, e.g. on the triggering of the correction mechanism and the setting of the required correction. Finally the legal status of the adopted national provisions differs greatly because of the diversity of the constitutional and legal frameworks of the Contracting Parties.

4. CONCLUSIONS

The basic aim of the Fiscal Compact and the TSCG in general was to strengthen budgetary discipline and improve economic policy coordination at a time of acute crisis. The Fiscal Compact was inspired by the notion that stronger national rules and institutions could increase the sense of ownership of EU fiscal rules and thereby play an important role in promoting sound fiscal policies, something which is confirmed by experience over the past years. The detailed analysis conducted by the Commission shows that the substance of the Fiscal Compact has been introduced in the national fiscal frameworks of all Contracting Parties.

At the time the objectives of the TSCG could not be achieved within the Union legal order. However, the TSCG foresees that the necessary steps towards the incorporation of its substantive provisions in the Union legal framework be taken within five years after its entry into force (that is, by 1 January 2018). Such incorporation would bring greater democratic accountability and legitimacy across the Union. It would also allow for a consistent evolution of the European and national fiscal rules and for more effective monitoring of their implementation. As argued in the Five Presidents' Report on Completing Europe's Economic and Monetary Union¹, a well-functioning EMU would benefit from the integration into the Union legal framework not only of the TSCG but of all inter-governmental instruments created during the crisis.

¹ https://ec.europa.eu/priorities/sites/beta-political/files/5-presidents-report_en.pdf