The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (Fiscal Compact Treaty)

Briefing note for Members

Abstract

This briefing paper examines the content of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (Fiscal Compact Treaty). It details existing fiscal rules under EU law, the main provisions of the Fiscal Compact Treaty and its legal nature.

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Introduction

The primary goal of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union ("the Fiscal Compact Treaty"), is to foster long-term budgetary disciple in the European Union (EU) and the Euro area.

While there has been much discussion on the treaty and how it will impose further restrictions on the design of national budgets, many of the treaty provisions are covered by existing EU law: the Stability and Growth Pact (SGP), and more recent reforms since the onset of the economic crisis, including the "six pack" and the European Semester. The major innovation in the Fiscal Compact Treaty is the introduction of the "golden rule" on the structural budget balance.

This briefing note provides details on the existing fiscal rules in EU law which Ireland, as a Euro area state, is already signed up to, and are already in force in Irish law, as well as detailing the main provisions of the Fiscal Compact Treaty from both economic perspective and a legal-institutional change perspective. The note goes on to briefly examine the legal nature of the treaty and the upcoming referendum.

A Glossary of key terms is included at the end of this document.

Background to fiscal discipline in the Economic and Monetary Union

The conditions for creation of the Economic and Monetary Union (EMU) were set out in the 1992 Maastricht Treaty. Maastricht set out in detail how the single currency would come into operation by 1 January 1999. Membership of the Euro area currency union, using the Euro, refers to Member States in the third stage of the EMU.

When the rules for the operation of the single currency were designed it was clear that for Member States to have a common monetary system economic converge was required. Entry to the EMU would not be automatic. The Maastricht convergence criteria were the first examples of centrally agreed fiscal rules in the EMU, with the aim of maintaining price stability (monetary discipline) within the prospective members of the Euro Area. The convergence criteria addressed monetary and fiscal conditions.

- **Inflation**: No more than 1.5 percentage points higher than the average of the three best performing member states of the EU
- **Long term nomination interest rate**: The nominal long-term interest rate must not be more than 2 percentage points higher than in the three lowest inflation member states.
- **Exchange rate**: Applicant countries should have joined the exchange-rate mechanism (ERM II) under the European Monetary System (EMS) for two consecutive years and should not have devalued its currency during the period.
- **Budget deficit**: The budget deficit should not exceed 3% of gross domestic product (GDP).
- **Public debt**: The ratio of the public debt should not exceed 60% of GDP or should be making reductions in that direction.

Both the UK and Demark negotiated opt-outs of the single currency.

The Stability and Growth Pact

The stability and growth pact (SGP) forms part of the rules and procedures for fiscal policy of the Member States of the Euro area. The SGP was agreed at the EU Summit in Dublin in December 1996. It built on the convergence criteria and lays out the rules for budgetary and fiscal discipline of the Member States. The focus of the SGP is to maintain the fiscal aspects of the converge criteria, namely the 3% deficit ratio and 60% of GDP public debt ratio.

The SGP consists of three elements:

- A definition of what constitutes an excessive deficit (see text box);
- A preventative arm designed to encourage governments to avoid excessive deficits. Member States must submit annual stability or convergence programmes (these are the April Stability Programme and then the October Update), showing how they intend to achieve or safeguard sound fiscal positions in the medium-term taking into account the impending budgetary impact of population aging. The European Commission ("the Commission") assesses these programmes and the Council of the EU ("the Council") gives its Opinion on them. The preventive arm includes two policy instruments:

    - The Council, on the basis of a proposal by the Commission, can address an early warning to prevent the occurrence of an excessive deficit.
    - Using the policy advice, the Commission can directly address policy recommendations to a Member State as regards the broad implications of its fiscal policies;

- A corrective arm which prescribes how governments should react to a breach of the deficit limit and includes sanctions. The corrective part of the Pact governs the excessive deficit procedure (EDP). The EDP is triggered by the deficit breaching the 3% of GDP threshold. If it is decided that the deficit is excessive in the meaning of the Treaty, the Council issues recommendations to the Member States concerned to correct the excessive deficit and gives a time frame for doing so. Non-compliance with the recommendations triggers further steps in the procedures, including for Euro area Member States the possibility of sanctions.

Text box: definition of the excess deficit

While allowing space for the automatic stabilisers to play their role (without recourse to deficit financing) participants in EMU commit to a medium-term (3 years) budgetary stance of being close to balance or in surplus[1]. Under the SGP, a deficit of the general government account of 3% of GDP is considered excessive. The SGP provides scope for temporary and exceptional events which may cause large deficits, although the deficit must remain close to the threshold. A deficit is considered exceptional if:

- It results from an unusual event outside the control of the Member State concerned which has a major impact on the financial position of the government;
- It results from a severe economic downturn, or periods of low growth (but not recession)

The scope for temporary overshoots allows for Member States to imlement structural reforms, which may carry short-term costs. The list of exemption for the temporary overshoot list is large. It includes R&D and other "European policy goals". The list is structured in such a way that governments should find it relatively easy to make the case for a temporary exemption.

The "Six pack" reforms (2010-2011)

In the wake of economic crisis, the Commission tabled proposals to reinforce the SGP with rules for economic governance and fiscal surveillance. The "Six pack" reforms, which consist of five regulations and a directive, entered into force towards the end of 2011.

Under the "Six-pack", actions under the excessive deficit procedure are quasi-automatic. In the case where a Euro Area Member State does not take action as advised a financial sanction can be imposed by the Council on the basis of a Commission recommendation. The Council must take action against the Member State unless a reverse qualified major decides against it.

The regular voting system in the Council of the European Union is qualified majority voting (QMV), whereby a majority of votes, weighted to each Member State to reflect its population, is required, and the majority must represent a majority of the EU as a

[1] However, the Stability Treaty makes this more restrictive, as it is now reads: "the budgetary position of the general government should be balanced or in surplus."

whole by population (the double majority rule). This is designed to avoid the formation of a blocking minority by, for example, a small number of large Member States, a number of small Member States representing a small part of the EU overall, or geographical alliances e.g. southern or northern Member States.

Rather than requiring a qualified majority to vote for the programme in the Council, the six-pack and the Fiscal Compact Treaty require that the programme agreed by the Commission is to be put in place unless a qualified majority vote *against* it (hence the 'reversal'). This has the benefit of it more difficult for those States who exceed the permissible deficits to avoid correction. Currently, 23 of the 27 Member States are part of the excessive deficit procedure.[2]

If the public debt to GDP ratio of 60% is not respected Member States will be required to reduce the gap between its debt level and the 60% reference value by 1/20th annually. Failure to do so will see the Member State being put into an excessive deficit procedure (EDP). Failure to adhere to this provision and further non-compliance will result in sanctions being taken which could lead to a maximum fine of 0.5% of GDP. This provision is referred to as the "debt brake" rule.

The six-pack includes expenditure benchmarks, to support public finance sustainability and guide member states towards their country specific, medium-term budgetary objective (MTO). This benchmark places a cap on the annual growth rate of public expenditure according to a medium term rate of growth.

This instrument is aimed at improving medium term budgetary planning and execution by ensuring that expenditure plans are adequately resourced by permanent revenues (not windfall or one-off revenues). This provision if violated, can lead to financial sanctions of 0.2% of GDP. This provision is only relevant however for countries which are not subject to an excessive deficit procedure.

[2] EU Press Release, "EU Economic governance 'Six pack' enters into force", 12 December 2011, http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/11/898

Surveillance of economic policies

The "six-pack" also contains a number of provisions which are aimed at broadening surveillance of member states' economic policies, over and above surveillance of budgetary issues highlighted above. These include two regulations with outline an "excessive imbalance procedure" accompanied with sanctions of up to 0.1% of GDP.

This aspect of the six-pack includes an early warning system which is based on the scorecard consisting of a set of ten indicators covering the major sources of macro-economic imbalances. If the indicators are breached it will trigger in-depth studies to determine whether the potential imbalances are benign or problematic. These reviews may be undertaken by the Commission and, where appropriate, the ECB. The text box below provides more detail on the scorecard and the specific indicators.

Planned scoreboard
3 year backward moving average of the current account balance as a percent of GDP, with the a threshold of +6% of GDP and - 4% of GDP;
net international investment position as a percent of GDP, with a threshold of -35% of GDP;
5 years percentage change of export market shares measured in values, with a threshold of -6%;
3 years percentage change in nominal unit labour cost, with thresholds of +9% for euro-area countries and +12% for non-euro-area countries.
3 years percentage change of the real effective exchange rates based on HICP/CPI deflators, relative to 35 other industrial countries, with thresholds of -/+5% for euro-area countries and -/+11% for non-euro-area countries;
private sector debt in % of GDP with a threshold of 160%;
private sector credit flow in % of GDP with a threshold of 15%;
year-on-year changes in house prices relative to a Eurostat consumption deflator, with a threshold of 6%;
general government sector debt in % of GDP with a threshold of 60%;
3-year backward moving average of unemployment rate, with the threshold of 10%.

The two charts below are scorecards according to the indicators of macroeconomic imbalances. Based on 2011 data, the first one shows the resulting score card for Euro area countries in the upper panel, and for non-euro area countries in the lower panel. All Member States, including candidate country Croatia, are deemed to have at least two of the ten imbalances.

Exhibit 1: RBC scorecard of macroeconomic imbalances

Euro area countries (ordered by size of economy):

	GER	FRA	ITA	SPA	NET	BEL	AUS	GRE	FIN	POR	IRE	SVK	LUX	SVN	CYP	EST	MAL
1: Current account (% of GDP, 3y average)	5.9	-1.6	-2.8	-6.5	5.5	-0.3	3.6	-12.1	2.7	-11.1	-2.7	-4.4	6.7	-2.9	-10.8	-0.5	-6.6
2: Net int'l investment position (% of GDP)	38	-11	-25	-89	27	77	-11	-92	9	-109	-97	-67	93	-36	-17	-72	7
3: Export market share (%, 5y change)	-11	-20	-17	-11	-3	-15	-15	-16	-26	5	-25	38	-22	-7	-20	5	-13
4: Unit labour costs (%, 3y change)	7.0	7.3	7.9	3.4	7.5	8.4	8.7	9.9	12.3	5.1	-2.2	10.0	17.3	16.5	7.2	9.3	7.7
5: Real effective exchange rate (%, 3y change)	-5.5	-4.3	-3.6	-2.9	-4.9	-2.4	-2.1	0.8	-2.9	-2.8	-10.5	2.5	-1.9	-1.9	-2.5	0.0	-3.5
6: Private debt (% of GDP)	131	211	161	293	252	232	153	135	86	250	402	112	*na*	*na*	*na*	*na*	*na*
7: Private credit growth (% of GDP, 1y change)	-5.6	3.1	11.6	0.7	-15.6	-2.7	-4.3	21.9	1.6	4.0	-25.7	2.5	-1.8	1.5	13.9	-10.0	-1.4
8: House prices (% y/y)	1.3	2.7	-2.5	-5.6	-2.3	2.9	2.6	-7.1	2.8	-0.2	-2.8	-6.4	-1.7	4.1	4.0	-0.4	-1.4
9: Public debt (% of GDP)	82	85	120	66	65	99	72	159	47	110	105	42	19	44	68	6	70
10: Unemployment (%, 3y average)	6.9	9.7	8.2	19.9	4.2	7.8	4.4	12.8	8.1	11.8	13.3	13.3	4.9	7.1	6.4	14.5	6.8
Total # of imbalances:	3	3	3	6	2	3	2	7	2	5	6	4	3	3	3	3	3

Non-euro EU countries (in alphabetical order):

	BUL	CRO*	CZE	DEN	HUN	LAT	LIT	POL	ROM	SWE	UK
1: Current account (% of GDP, 3y average)	-11.0	-5.0	-2.5	3.8	-1.6	-0.3	-2.4	-5.0	-6.7	7.3	-2.2
2: Net int'l investment position (% of GDP)	-100	-93	-52	10	-110	-80	-57	-65	-65	-17	-25
3: Export market share (%, 5y change)	21	-7	18	-20	5	19	22	24	23	-16	-24
4: Unit labour costs (%, 3y change)	29.4	0.0	5.4	11.0	5.0	-0.2	1.2	10.8	30.7	6.0	11.3
5: Real effective exchange rate (%, 3y change)	10.5	-3.4	12.6	1.1	-0.2	9.0	9.9	-0.4	-10.2	-2.3	-19.7
6: Private debt (% of GDP)	*na*	*na*	142	267	188	*na*	127	110	212	275	229
7: Private credit growth (% of GDP, 1y change)	-1.3	4.2	0.9	-7.1	-0.1	-5.4	-5.2	1.9	-0.9	-0.2	-9.6
8: House prices (% y/y)	-6.1	1.2	1.1	4.0	4.3	-9.7	-15.0	22.7	-0.6	0.8	-2.5
9: Public debt (% of GDP)	15	44	40	49	83	45	38	56	33	37	85
10: Unemployment (%, 3y average)	9.4	11.4	6.9	7.0	10.7	17.3	15.8	9.2	7.1	8.1	7.8
Total # of imbalances:	3	4	2	2	4	2	2	3	4	3	4

Sources: Haver, IMF, WB, Eurostat, national central banks, RBC Capital Markets. *Croatia to join the EU on 1 July 2013.

The second chart is a retrospective scorecard for Ireland for the period 2001-2010 that was compiled by Seamus Coffey, an economist at UCC, and presented to the Oireachtas Joint Committee on 22 February 2012. As his note to the Committee explains in the period 2001-2006 there was no year in which Ireland satisfied all thresholds. The trend in the more recent years is clear where 6-7 indicators breach their threshold levels.

Ireland: scorecard on macroecomic imbalances 2001-2010

Column1	Ireland	Thresholds	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
External imbalances and	3 year average of Current Account Balance as a percent of GDP	Neg 4% /+6%	-0.3	-0.7	-0.5	-0.5	-1.4	-2.5	-4.1	-4.8	-4.6	-2.7
	Net International Investment Position as % of GDP	-35%	-15.1	-17.8	-20	-17.9	-24.5	-5.3	-19.4	-75.7	-103.1	-90.9
	% change (3 years) of Real Effective Exchange Rate (REER) with HICP deflators	plus/minus 5% & plus/mminus 11%	-2.2	4.4	17.6	17.5	12	3.4	4.1	8.1	5.3	-5
	% Change (5 years) in Export Market Shares	-6%	64	60	26.6	12.6	5.9	-12.5	-15.7	-21.2	-5.6	-12.8
	% Change (3 years) in Nominal ULC	9%& 12%	10.3	10	10.5	8.6	13.9	14.4	14.6	16.6	9.4	-2.3
Internal imbalances	% y-o-y change deflated House Prices	6%	3.6	4.9	11.3	9.5	9.7	12	4	-9.7	-15.1	-10.5
	Private Sector Credit Flow as % of GDP	15%	na	23.9	9.5	25.2	24.8	34.4	25.7	40.9	3.7	-4.5
	Private Sector Debt as % of GDP	160%	149	160	154	171	192	205	215	284	336	341
	Public Sector Debt as % of GDP	60%	32	31	29	27	25	25	25	44	65	93
	3 year average of Unemployment	10%	4.6	4.2	4.3	4.5	4.5	4.4	4.5	5.1	7.6	10.6

The European Semester (2010)

The European Semester is a further element of the new architecture for economic governance in the EU. Under these reforms the EU and the Member States agree to coordinate *ex ante* their budgetary and economic policies, in line with the SGP and the Europe 2020 Strategy.

On the basis of the Commission's Annual Growth Survey, Member States at the Spring Council summit identify the main challenges facing the Union and the single market. Taking this analysis into account Member States present and discuss their medium term budgetary strategies through the Stability and Convergence Programmes and National Reform Programme[3]. Based on the assessment of the Commission which examines these reports to ensure they are aligned with the goals agreed at the Spring Council Summit, the Council issues country specific guidance.

[3] http://ec.europa.eu/economy_finance/economic_governance/sgp/convergence/programmes/2011_en.htm

Each July, the Council provides policy advice to Member States as they finalise their budgets for the following year.

Text box: Do fiscal rules work?

While empirical evidence points to the correlation of fiscal rules with fiscal rectitude (IMF, 2009), there remains some uncertainty about the direction of causation. Fiscal rules may be adopted because of fiscal rectitude rather than the other way around.

Furthermore, as Hagemann (2012) acknowledges: "a poorly designed rule can be more harmful than helpful". Numerical rules can suffer from a number of weaknesses - they can be pro-cyclical and where political commitment to the rules is lacking, they can motivate creative accounting.

Part of the problem with assessing the effectiveness of fiscal rules is that there are different types of rules and they have different objectives. The different rules are usually categorised under four headings:

1. Balance budget rules
2. Debt rules
3. Expenditure rules
4. Revenue rules

The different objectives of fiscal rules can be further categorised under three headings: debt sustainability, economic stabilisation and expenditure efficiency. Furthermore each of the rules can have negative effects, for instance they can introduce an element or pro-cyclicality or be inflexible in the face of sudden crises.

Source: International Monetary Fund (2009), "Fiscal Rules—Anchoring Expectations for Sustainable Public Finances"

The Fiscal Compact Treaty

As outlined in the previous sections, many of the rules in the Fiscal Compact Treaty are provided for in existing EU law. The provisions of the Treaty do not alter the provisions of any existing stabilisation programmes (bailouts). Furthermore, under the Six Pack, all countries that are subject to an excessive deficit procedure have a three year transitional grace period before they would have to conform to the provisions of the Treaty. Ireland is already involved an the excessive deficit procedure to bring its general government deficit down to 3% and has a target date of 2015 for doing this, after which the three year transitional period would apply.

This section highlights the main provisions of the Treaty as they relate to fiscal discipline.

Title III: Fiscal Compact

Budgetary discipline

The goal of the Treaty is to foster budgetary discipline. Title III of the Treaty, which consists of Article 3, addresses this. Article 3 confirms that the general fiscal stance should be one where the general government budget should be in balance or in surplus. Contracting Parties must ensure that the medium term objective (MTO), a country specific budgetary target but which takes account of the country's economic potential, implicit liabilities due to ageing population etc., is observed. An aligned purpose of the MTO is that it allows for the "rapid convergence of debt ratios" to the 60% reference value.

The main innovation of the Treaty is that it introduces a structural balance deficit rule, referred to as the "Golden Rule." Under this provision, Member States may not have a structural deficit greater than 0.5% of GDP. For countries whose public debt is significantly below 60% of GDP, they may run a structural deficit of up to 1% of GDP. The SGP deficit rule of 3% remains. If a Member State deviates from this golden rule, a correction mechanism which shall include obligations on the Member State to implement corrective actions over a defined period of time will be triggered automatically.

The structural balance is the general government balance adjusted for changes in the business cycle. Unlike the general government deficit which is has a real numerical value attached to it, the structural budget balance is a theoretical concept with numerous measurement issues surrounding it. This may create significant issues for the EU to make this provision operational. As Marcellino (2012) puts it:

> “The problem of a target in terms of structural balance is that this variable is not observable. It must be constructed by cyclically-adjusting the actual balance. There is no consensus about how to measure the business cycle even among economists, so it can be expected that member states will have very different opinions about the state of their business cycle and hence about the meaning and measurement of "structural balance". In addition, it is not obvious from an economic point of view that growth promoting expenditures, such as investment in education and research, should be included in the computations.”

There is significant debate about the importance of creating sufficient fiscal space for governments to be able to run a counter-cyclical fiscal policy. While it may be desirable from some perspectives to “bank” surpluses during the expansionary phase of the economic cycle to allow for large deficits in times of recession, others would argue that it should be possible for governments to increase the level of public debt in the medium term to support deficit spending during a recession[4].

The rules in Article 3 must be implemented through national law. Failure to implement these rules will give rise to enforcement proceedings before the European courts and a possible fine. The issue of enforcement is addressed in more detail below.

Debt brake

Article 4 establishes the “debt brake” which was originally instituted in the “six-pack”. This is the provision requiring Member States to reduce the gap in the level of public debt to GDP ratio to 60% by 1/20th annually.

[4] However, to raise these concerns at this stage is again to run against what was agreed in 1996 in the SGP.

Excessive Deficit Procedures

Article 5 confirms the SGP provisions relating to excessive deficit procedures and the requirement of Member States to put in agreed programmes to correct the deficit. Article 7 makes the provisions of the SGP as they relate to Euro Area Member States, automatic, unless a reverse qualified majority opposes them. This has the benefit of making it more difficult for those States who exceed the permissible deficits to avoid correction. Currently, 23 of the 27 Member States are part of the excessive deficit procedure.

The regular voting system in the Council of the European Union is qualified majority voting (QMV), whereby a majority of votes, weighted to each Member State to reflect its population, is required, and the majority must represent a majority of the EU as a whole by population (the double majority rule). This is designed to avoid the formation of a blocking minority by, for example, a small number of large Member States, a number of small Member States representing a small part of the EU overall, or geographical alliances e.g. southern or northern Member States.

Rather than requiring a qualified majority to vote for the programme in the Council, the six-pack and the Fiscal Compact Treaty require that the programme agreed by the Commission is to be put in place unless a qualified majority vote against it (hence the 'reversal').

Public Issuances of debt

The provision outlined in Article 6, require Contracting Parties to outline plans for the issuance of public debt.[5]

Titles IV and V: Economic Policy Coordination and Convergence

Articles 9 to 11 inform the second main goal of the Fiscal Compact Treaty, namely the enhanced convergence of the Euro area, "in pursuit of the objectives of fostering competitiveness, promoting employment, contributing further to the sustainability of

[5] The relevance of this is questionable as most public debt is issued to roll over existing debt whose maturities are known in advance.

public finances and reinforcing financial stability”. Article 11 goes on to state that the Contracting Parties shall “ensure that all major economic policy reforms that they plan to undertake” will be discussed prior to implementation and where appropriate in coordination among themselves and involving the EU institutions.

Euro Summit

Economic governance of the Euro area is currently the responsibility of the Eurogroup. The Eurogroup is a collection of the Ministers for Finance of the Euro area Member States. It is therefore a subgroup of the ECOFIN Council – the configuration of the Council of the EU which brings together the 27 Finance Ministers of the EU (there are currently 10 configurations in different policy areas). It was formalised by the Treaty of Lisbon (Protocol 14) and elects a President for a term of two and a half years. The current President is Jean-Claude Junker, Prime Minister (and former finance minister) of Luxembourg.

Article 12 of the Fiscal Compact Treaty institutionalises the Euro Summit. The Euro Summit is a meeting of the Heads of State or Government of the Euro area states, plus the President of the Commission, therefore making it effectively a subgroup of the European Council. The Euro Summit is obliged to invite the President of the European Central Bank to attend meetings. The President of the Eurogroup may also be invited to the meetings (but there is no obligation to invite him).

The Euro Summit shall meet at least twice a year, to discuss:

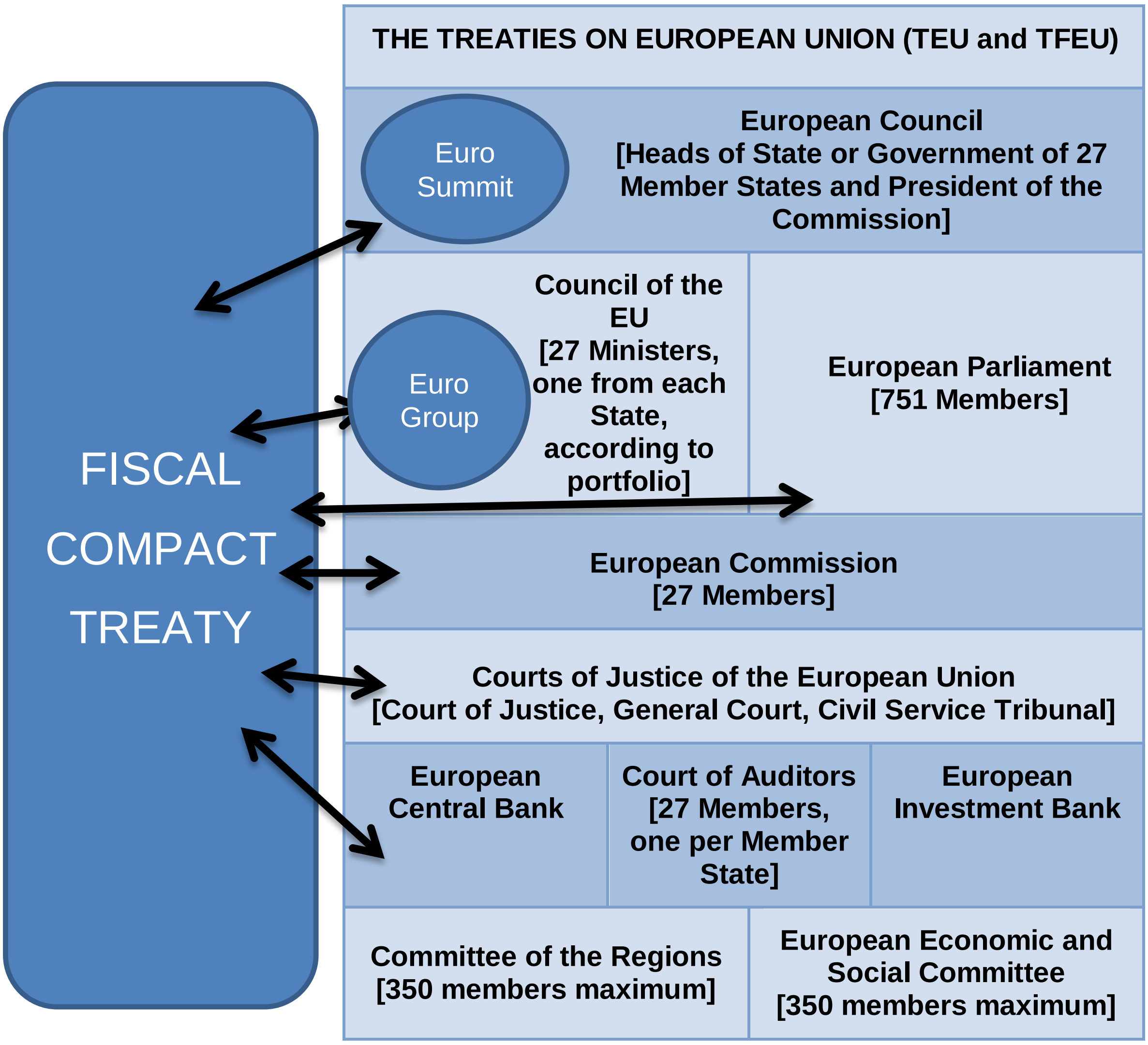
- Questions related to the specific responsibilities shared by Euro area states in relation to the single currency;
- Issues concerning the governance of the Euro area, and the rules that apply to it; and
- Strategic orientations for the conduct of economic policies to increase convergence in the euro area.

Article 12(3) allows *non-Euro area* Contracting Parties to participate in Euro Summit discussions concerning:

- Competitiveness for the contracting parties to the Fiscal Compact Treaty;

- Modification of the global architecture of the Euro area;
- The fundamental rules that will apply to the Euro area in future; and
- (at least once a year) the implementation of the Fiscal Compact Treaty.

The following figure indicates how the role of the EU institutions interacts with the Fiscal Compact Treaty:



The Euro Summit will elect a President by simple majority at the same time as the election of the President of the European Council (the current President is Herman Van Rompuy). Commentators have suggested that this increases the likelihood that the same person will be elected to both posts.[6] The current term ends in May 2012 although it is unlikely that the Treaty will have entered into force by then. The first date upon which the election of Presidents of the European Council and the Euro Summit will coincide is therefore December 2014.

The President will be charged with the preparation and continuity of Euro Summit meetings (in close co-operation with the President of the Commission) but the body charge with the preparation of the Euro Summit meeting is the Eurogroup. The President of the Euro Summit must keep the contracting non-euro states 'closely informed' of the preparation and outcome of Euro Summit meetings (Art. 12(6)).

The President of the European Parliament may be invited to address the Euro Summit, the President of the Euro Summit must report to the European Parliament after each meeting of the Summit.

Article 12 will enter into force for *all* Contracting Parties from the date of entry-into-force, not just those who have completed the ratification procedure.

Enforcing Implementation of the Fiscal Rules

As mentioned above, the fiscal rules and the corrective mechanism in Article 3(1) must be implemented by national law at the latest one year from the entry into force of the Treaty. Such national law must be binding and permanent and 'preferably constitutional'.

Enforcement of the Fiscal Compact Treaty rules takes place at a number of levels, both inside and outside a contracting Member State. Article 3(1)(e) of the Fiscal Compact Treaty requires the automatic trigger of a 'correction mechanism' in the event of deviations from the medium-term objective, or the adjustment path towards it.

Article 3(2) requires the Contracting Parties to put the correction mechanism in place at national level, as well as implementing all the rules contained in Article 3(1). This

[6] Peadar O Broin, ibid

correction mechanism will be based on common principles to be proposed by the European Commission and will relate to the nature, size, and time-frame of ‘corrective action’, and in exceptional circumstances the ‘role and independence of the institutions responsible at national level for monitoring the observance of the rules.’ Article 3(2) specifies respect for the prerogatives of national parliaments in this corrective mechanism.

Such initial enforcement is therefore at national level (though in practice shaped by standards of the European Commission) and automatic.

Article 8 requires the European Commission to report to the Contracting Parties on their progress in putting in place the rules as required by Article 3(2). If the Commission, having received observations from the Contracting Party in question, concludes that there has been a failure by that state to put any of the rules in place, the matter must be referred to the Court of Justice of the EU by one or more Contracting Parties.

The judgment of the Court is binding and the offending party will have to comply with the judgment in a timeframe set down by the Court.

If the offending Party does not comply with the judgment of the Court it can bring the matter to the Court a second time, requesting financial sanctions to be imposed. Such financial sanctions would follow criteria set down in Article 260 TFEU. The Court has the power to impose either a lump sum or a penalty payment, up to a maximum of 0.1% of the offending party’s GDP.

If the Contracting Party is a Euro area state, the money goes into the European Stability Mechanism, if not, payments are made to the general budget of the EU.

There is a legal basis within the EU Treaties that gives the Court jurisdiction to adjudicate on ‘special agreements (Article 273 TFEU). The Fiscal Compact Treaty asserts its status as a special agreement under that provision.

At the time of writing the procedures under which the Court will handle such matters under the Fiscal Compact Treaty were still under negotiation.

Ratification

Article 14 addresses the entry into force of the Fiscal Compact Treaty. Ratification takes place according the requirements of each state under its own national law, and its 'instrument of ratification' is to be deposited in Brussels at the Council of the EU.

As long as 12 of the 25 Contracting Parties ratify the Treaty, it will enter into force on 1 January 2013, or if 12 ratifications are deposited before then, the first day of the month following the twelfth ratification (so if the twelfth ratification is deposited on say, 15th October, the date of entry into force would be 1st November).

For Euro area countries who have ratified the Treaty it will apply from the date of entry into force. For those who ratify after the date of entry into force it will apply from the month following ratification (so if a Euro area State ratifies on 8th February 2013, the Treaty will apply to that state from 1st March 2013).

There is an exception to this general rule. Article 12, on the Euro Summit, shall apply to all Euro area states, irrespective of their ratification status, from the date of entry into force.

The effects of non-ratification are primarily referred to in the 24th paragraph of the preamble:

> "STRESSING the importance of the Treaty establishing the European Stability Mechanism as an element of a global strategy to strengthen the Economic and Monetary Union and POINTING OUT that the granting of assistance in the framework of new programmes under the European Stability Mechanism will be *conditional*, *as of 1 March 2013, on the ratification of this Treaty* by the Contracting Party concerned and, as soon as the transposition period mentioned in Article 3(2) has expired, on compliance with the requirements of this Article," (emphasis added)

Thus, any access to the ESM facility from March 2013 is conditional on:

- Ratification of the Fiscal Compact Treaty; and
- Putting a corrective mechanism in place under national law as required by Article 3(2).

Role of National Parliaments

Article 13 of the Fiscal Compact Treaty makes reference to the role of national parliaments under the European Treaties, and states that in the light of that role the European Parliament and national parliaments of the Contracting Parties will together:

> "determine the organisation and promotion of a conference of representatives of the relevant committees of the national parliaments and representatives of the relevant committees of the European Parliament in order to discuss budgetary policies and other issues covered by this Treaty."

Peadar O Broin of the Institute of International and European Affairs (IIEA) notes that "parliamentary participation in the national budgetary process is an essential component of democratic legitimacy of the process, and is particularly importance for Germany, whose Federal Constitutional Court ruled in 2011 that the Bundestag's budgetary committee must play a central role in implementation and oversight of national budget rules."[7]

[7] Peadar O Broin, ibid, at p. 10

The legal status of the Fiscal Compact Treaty

Unanimous support from all 27 Member States is required to bring about change to the European Treaties: the Treaty on European Union (TEU) and the Treaty on the Functioning of the European Union (TFEU). Such treaty change was effectively blocked by the decision of the United Kingdom not to support the incorporation of the reinforced SGP rules into the treaties at December's European Council meeting. The UK European Union Act 2011 requires the British government to hold a referendum on any change to the EU Treaties that transfers powers from Member States to the EU institutions, an eventuality which, commentators suggest, Prime Minister David Cameron may have been keen to avoid.[8]

Text Box: International Agreements

The Vienna Convention gives Heads of State or Government full powers to conclude international agreements, which may be known as treaties, conventions, protocols, covenants etc. Sovereign states and international organisations are subjects of international law.

An international agreement, like a contract, is binding on the contracting parties but does not affect third parties. International agreements generally do not form part of national law in the sense that they do not create rights or duties for individual citizens and cannot be invoked before national courts.

The **EU Treaties** are also international agreements, but they have a special character as they form the apex of an autonomous legal order. Its provisions and secondary legislation do form part of national law and can, in certain circumstances, be invoked by citizens before national courts.

Germany therefore proposed the conclusion of a stand-alone international agreement, negotiated between and ratified by as many EU Member States as possible, with a particular focus on members of the Euro area. It is outside the legal framework of the European Union. The SGP rules up to 2012 will apply to all 27 Member States, with the *new* rules contained in the Fiscal Compact Treaty applying to the 25 contracting parties (the UK and the Czech Republic will not take part).

The Fiscal Compact Treaty is not however designed to conflict with the parallel European Treaties, but rather to act as a bridge to eventual incorporation if unanimity

[8] Peadar O Broin, "The Euro Crisis: The Fiscal Compact Treaty – An Initial Analysis," Working Paper 5, IIEA, 2012, available at http://www.iiea.com/publications/the-euro-crisis-the-fiscal-treaty--an-initial-analysis

becomes possible in the future. There is some precedence for this type of approach in the Schengen and Prüm Treaties, which were completed outside the Union framework but subsequently incorporated into the Treaties.[9] Similarly, Ireland's 'legal guarantees' annexed to the Lisbon Treaty are an international agreement required to be incorporated into the EU Treaties at the earliest opportunity.

Who's who	
EU Member States	27
Contracting Parties	25
Euro area States	17
Non-Euro area Contracting Parties	8
Member States not party to Fiscal Compact Treaty	2 (UK, CZ)

Title II is concerned with the Fiscal Compact Treaty's 'consistency and relationship with the law of the Union', and attempts to make this 'bridge' clear. Article 2 creates an obligation on the Contracting Parties to apply and interpret the Fiscal Compact Treaty 'in conformity with the Treaties on which the European Union is founded…" It makes particular reference to EU law, and procedural law "whenever the adoption of secondary legislation is required."

As explained above, acts adopted as between Member States but not on the basis of the EU Treaties are in the nature of international law. Lenaerts and Van Nuffel state:

> "where such acts are closely connected with the objectives of the [Union] or with [Union] acts, their legal effects are likely to be influenced by [Union] law, in particular the obligations imposed by the principle of co-operation in good faith on Member States also in respect of non-[Union] action."[10]

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[9] The Schengen Agreement (1985) related to the abolishing of border controls between a number of EU Member States. Ireland and the United Kingdom, as members of the Common Travel Area do not take part. The Prum Convention (2005) involved an agreement amongst seven EU Member States on cross-border cooperation including the exchange of data on vehicle registrations, DNA and fingerprints, and to cooperate in anti-terrorism measures.

[10] Lenaerts & Van Nuffel, *Constitutional Law of the European Union*, 2nd ed., London: Thomson, (2005), at p. 798.

A number of recent Accession Acts have stated that multilateral acts adopted by the Member States outside the institutional structure form part of the body of Union law to be implemented by future members.[11]

Article 2 also refers directly to Article 4(3) of the TEU: the 'duty of loyal cooperation'. This duty is a fundamental principle of EU law, and requires all Member States not to undermine or frustrate the operation of EU treaty rules, and respect the rights of EU institutions in implementing its rules. The effect of Article 2 is to require Contracting Parties to respect both the letter and the spirit of EU law as part of its duty as a Member State of the Union. An interpretation of the Fiscal Compact Treaty which is irreconcilable with the EU Treaties is therefore invalid.

In conclusion, the Fiscal Compact Treaty has the legal status of an international agreement but it is effectively subordinate to the EU Treaties in the Union legal order, in the sense that it cannot amend the EU treaties and it must be interpreted in conformity with the EU treaties.

Why a referendum?

As discussed above, the Fiscal Compact Treaty is an international agreement closely linked to, though outside, the EU Treaties, and the legal order they create. An Taoiseach Enda Kenny announced in the Dáil that the view of the Attorney General, Máire Whelan, is that the Fiscal Compact Treaty "is a unique instrument outside the EU treaty architecture and, on balance, a referendum is required to ratify it".

Carol Coulter, Legal Editor of the *Irish Times* explained this position:

> "The EU "treaty architecture" is outlined by article 29 of the Constitution, entitled International Relations, and lists the various treaties signed up to by the State, starting with the treaties of Paris and Rome adopted by our decision to join the European Union, and continuing with the various others, including the Single European Act, the Maastricht and Amsterdam Treaties and various protocols, and the Nice Treaty.

[11] Article 5(2) of the Act concerning the conditions of accession of the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland Slovenia, the Slovak Republic to the European Union, [2003] OJ (L236/33); Article 4(2) of the Act concerning the conditions of accession of Austria, Finland and Sweden to the European Union, [1994] OJ (C241/9)

> Article 29 then protects various EU laws and measures from constitutional challenge by stating they are not unconstitutional if "*necessitated by the obligations of membership of the European Union or Communities*".
>
> It does not refer to any subset of EU institutions, for example, an inter-governmental conference, such as decided on the fiscal compact treaty.
>
> *The fiscal compact treaty is not necessitated by membership of the EU or EC*, as it applies only to those states which agree to sign it. Already the UK and the Czech Republic have refused to do so, and membership of the EU, as distinct from membership of the euro currency, is not dependent on doing so.
>
> As Prof Gerry Whyte of Trinity College has pointed out, the fiscal compact treaty involves a transfer of sovereignty to EU institutions and this is a very important constitutional matter.
>
> As such, a transfer of sovereignty is not covered by article 29 of the Constitution, a referendum on it is, he said, "prudent", a view clearly shared by the Attorney General." (emphasis added)

An Taoiseach signed the Fiscal Compact Treaty on 2nd March 2012. This signature represents an intention to ratify the agreement, consisting of the signed text as concluded.

Glossary

Annual Growth Survey (AGS): Presented by the Commission at the start of each year, the AGS sets out the economic priorities for the EU to boost growth and jobs for the next twelve months. The AGS is the basis for the Spring European Council to issue its guidance, which is then translated into national plans by April/May. The presentation of the AGS also marks the start of the European Semester.

Economic and Monetary Union (EMU): an umbrella term for the group of policies aimed at converging the economies of members of the European Union in three stages so as to allow them to adopt a single currency, the euro. As such, it is largely synonymous with the Eurozone/Euro area.

Euro+ Pact: The Euro+ Pact is a complementary agenda to the AGS, setting out additional reforms to which the euro area Member States have committed, and to which other Member States can sign up if they wish (Bulgaria, Denmark, Latvia, Lithuania, Poland and Romania have done so). The Pact, agreed in March 2011, focuses on competitiveness, employment, sustainability of public finances and reinforcing financial stability.

Europe 2020: sets out a vision for Europe's social market economy over the next decade, and rests on three interlocking and mutually reinforcing priority areas: Smart growth, developing an economy based on knowledge and innovation; Sustainable growth, promoting a low-carbon, resource-efficient and competitive economy; and Inclusive growth, fostering a high-employment economy delivering social and territorial cohesion.

Progress towards these objectives will be measured against five representative headline EU-level targets, which Member States will be asked to translate into national targets reflecting starting points:

- 75 % of the population aged 20-64 should be employed.
- 3% of the EU's GDP should be invested in R&D.
- The "20/20/20" climate/energy targets should be met.
- The share of early school leavers should be under 10% and at least 40% of the younger generation should have a degree or diploma. .

- 20 million less people should be at risk of poverty.

European Financial Stability Facility (EFSF) – Established in May 2010, the EFSF is an inter-governmental body able to lend up to €440bn to euro area countries in need of financial support. The euro area Member States themselves provide the loan guarantees. The EFSF will be replaced as from 1 July, 2013 by the ESM.

European Financial Stabilisation Mechanism (EFSM) – Also set up in May 2010, the EFSM is available to provide loans of up to €60bn to euro area Member States in need of financial support. The EFSM is guaranteed by the Community budget, without being effectively paid from the budget itself. The EFSM will also be replaced by the ESM as of 1 July, 2013.

European Semester: The EU and the Member States agree to coordinate in advance their budgetary and economic policies according to a set timetable that begins with the Annual Growth Strategy.

European Stability Mechanism (ESM) – The EU's permanent crisis resolution mechanism will be operational from 1 July, 2013. It will replace the EFSM and the EFSF as the vehicle through which financial assistance will be provided to euro area Member States in need. Assistance will be on the basis of strict policy conditionality and tied to a macro-economic adjustment programme. The terms of the ESM were agreed at the March 2011 European Council. It will have an effective lending capacity of €500bn. To allow for the establishment of the ESM, a change has been agreed to Article 136 of the Treaty on the Functioning of the EU.

Golden Rule: Member States may not have a structural deficit greater than 0.5% of GDP. For countries whose public debt is significantly below 60% of GDP, they may run a structural deficit of up to 1% of GDP.

Medium term objectives (MTO): The MTO is a county specific budgetary target which takes account of the country's economic potential and other factors such as the implicit liabilities due to ageing populations.

Stability and Growth Pact (SGP): The Stability and Growth Pact is the framework through which the EU ensures the fiscal sustainability of all 27 Member States and of the euro area in particular. The reforms to the EU's economic governance agreed in December 2011 will make the SGP clearer, stronger and more effective, at both the prevention and enforcement stages. Public debt and public deficit criteria will be placed on an equal footing for the first time. Member States will be required to make significant progress towards medium-term budgetary objectives and expenditure growth will have to be kept in line with GDP growth. The Commission will recommend fines of 0.2% of GDP for euro area countries which fail to take corrective action to achieve these objectives within an agreed timeframe. These fines will apply unless a qualified majority of Member States votes against them.

Six Pack: Five regulations and one directive updating the SGP. It significantly revises the rules on EU-level oversight of Euro area Member States' budgets, in particular by improving the SGP's enforcement regime:

- Regulation (EU) No 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
- Regulation (EU) No 1174/2011 of the European Parliament and of the Council of 16 November 2011 on enforcement measures to correct excessive macroeconomic imbalances in the euro area
- Regulation (EU) No 1175/2011 of the European Parliament and of the Council of 16 November 2011 amending Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies
- Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances
- Council Regulation (EU) No 1177/2011 of 8 November 2011 amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure
- Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States

Percentage points: is the unit for the arithmetic difference of two percentages. Consider the following hypothetical example: In 1980, 40% of the population smoked, and in 1990 only 30% smoked. We can thus say that from 1980 to 1990, the incidence of smoking decreased by 10 percentage points even though smoking did not decrease by 10% (actually it decreased by 25%) – percentages indicate ratios, not differences.

Gross Domestic Product (GDP): Refers to the market value of all officially recognized final goods and services produced within a country in a given period