The EU Fiscal Compact: Constitutionalization of Austerity and Preemption of Democracy in Europe

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1. Introduction

Confronted with the deepest economic and political crisis of the EU since its inception, European political leaders signed on March 2, 2012 the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (a.k.a. the Fiscal compact). The Fiscal compact was signed by all the member states of the EU, except the UK and the Czech Republic. Lacking a unanimous support of all the member states, the Fiscal compact could not be adopted as an amendment to the European Union treaty. Instead, it took the form of a separate inter-governmental Treaty requiring at least twelve euro area members to ratify the Fiscal compact until January 1, 2013. So far, five euro area members and two EU member states have ratified the Fiscal compact.

The Fiscal compact requires ratifying member states to enact laws, preferably of a constitutional nature, requiring national budgets to be in balance or in surplus. The treaty defines a balanced budget as one which has a general budget deficit less than 3% of GDP and a structural deficit of less than either 0.5% or 1%, depending on a country's debt-to-GDP ratio. The aim of this “golden rule” of balanced budgets is to ensure budgetary discipline among the EU governments. Another element of the Fiscal compact is so called “debt brake” modeled upon the German constitutional provision requiring the federal government to reduce its structural deficit to 0.35% of GDP by 2016. The treaty also places compliance with its budgetary and other requirements under the jurisdiction of the European Court of Justice.

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As one observer noted, the Fiscal compact essentially outlaws one side of the debate how to deal with the euro zone crisis. While it elevates the austerity paradigm of the German Chancellor Angela Merkel to the status of “unbreakable law”, it basically outlaws Keynesianism and its counter-cyclical economic policies. Furthermore, the Fiscal compact deviates from traditional EU values of democracy and the equality of member states. As we argue in the legal analysis of the compact, it empowers European bureaucrats, judges and bankers at the expense of European citizens. As a result, the Fiscal compact seriously preempts the most basic democratic principles and values of the EU. One European scholar argues that the Fiscal compact is the most unbalanced and asymmetric EU agreement that member states have ever signed. If adopted and implemented, it will have long-term negative economic, legal and political consequences for the EU as a whole and for the member states as well.

Using legal and economic analysis, we argue that the Fiscal compact needs a substantial revision. Such a revision, we aim to show, would not inevitably lead to the fiscal union, as the taxpayers from the core countries may fear, but rather to a more balanced, more inclusive and pluralistic EU. The attempt to impose top–down, one-size-fits–all, rigid and restrictive fiscal rules should be replaced by the much more decentralized approach toward fiscal, economic and political reconstruction of the EU.

Several Nobel Prize winners in economics who are generally supportive of the EU project, including Paul Krugman, Joseph Stiglitz and Amartya Sen, are not the only ones who have expressed their deep concerns about the flawed European response to the crisis, which includes the adoption of the EU fiscal compact. Several leading European figures, such as Jacques Delors, Jürgen Habermas and one of the leading EU legal experts Jean Claude Piris also remain highly critical of the EU’s misdirection. The most concise and clearest explanation as to why the generalized European austerity cannot work and why it shall in effect further undermine the confidence of financial markets was provided by Paul de Grauwe, one of the preeminent scholars of European monetary integration:

When all eurozone countries are forced to accept austerity at the same time, deflationary forces are set in motion that lower output and government revenues throughout the eurozone. As a result, government budget deficits do

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3 Fintan O'Toole, Treaty seeks to outlaw one side of the debate, March, 6, 2012, The Irish Times.
5 José Ignacio Torreblanca, 'Time to say 'basta' to the nonsense of austerity', Financial Times, April 25, 2012.
not decline sufficiently to prevent debt-to-GDP ratios from increasing, as the denominator in these ratios (GDP) goes down faster than the numerator (the debt level). Thus, the effect of generalised austerity is recession and more unsustainable levels of government debt. Generalised austerity undermines the confidence of financial markets, because it leads the eurozone straight into a recession.⁶

As we shall present in our analysis, the adopted fiscal compact cements the deeply flawed European direction. Failing to address the real causes of the euro zone crisis and to offer adequate economic solutions to the crisis, it could only plunge the EU into a deeper and prolonged economic depression. We argue that an alternative economic and political strategy is needed.

Until the May 2012 elections in France and Greece, it seemed as if the Fiscal compact enjoyed almost unanimous support among the European political leaders. When Merkel and Sarkozy agreed in October 2010 in Dauville to constitutionalize their economic policy of austerity, their decision soon became virtually unchallenged new economic doctrine of the entire EU. However, with the election of a new French president, the Fiscal compact acquired its most vocal critic. One of Francois Hollande’s most important election promises was to renegotiate the Fiscal compact. With the euro zone debt crisis further deteriorating, other important institutions such as IMF and the US Treasury also voiced a strong criticism of the austerity orthodoxy and urged for a new pro-growth approach. As a consequence, during the June 2012 Euro Area Summit the debate shifted from austerity to growth and several EU leaders urged for a new growth pact to complement the Fiscal compact. However, while making certain important concession to the pro-growth advocates (Hollande and Monti)⁷, the conclusions of the Summit felt short of producing a more ambitious alternative to Merkel’s austerity policy.

At the moment, the destiny of the Fiscal compact seems to be in the judicial hands. Next month, the German Constitutional Court is expected to rule on the constitutionality of the compact. The Left Party (die Linke) together with 35.000 citizens supporting the More Democracy movement in their legal challenge argue that the Fiscal compact transfers powers to Brussels without democratic control and therefore violates the basic principle of


⁷ The Summit conclusions contain also an annex entitled «A Compact for Growth and Jobs», European Council 28/29 June 2012 Conclusions.
parliamentary sovereignty of the German constitution. Prominent German legal scholars expect that the Court may use this opportunity to suggest a national referendum is held before budget sovereignty is transferred to EU institutions. That the Fiscal compact is losing its political momentum is also apparent from some recent political initiatives which question the core premises of the Fiscal compact. Emile Roemer, the leader of the Dutch Socialists, the party leading opinion polls ahead of the next month general elections, announced that his party would demand a referendum on the EU Fiscal compact. He also mentioned that his party will resist the Fiscal compact. Ed Miliband, the leader of the British Labor party, after meeting Hollande, acknowledged that the tide was turning against austerity with Hollande in power.

The following analysis is divided into an economic discussion and a legal analysis of the Fiscal compact. We conclude with the list of alternative proposals to the EU Fiscal compact.

2. The economics of the Fiscal compact: too rigid and too restrictive

Contrary to its declared goals, the Fiscal compact shows that it does not lead to good fiscal policy. It tries to secure the moderate and sustainable levels of public debt at the levels of the national government. Such a declared goal is reasonable and legitimate. However, the problem is that legally binding limits imposed by the Fiscal compact are too rigid and too restrictive to allow such a reasonable fiscal policy. Karl Whelan from the University College Dublin analyzed the so-called golden rule. Despite the desirability of achieving moderate and sustainable levels of public debt and the need to return the country's debt to a 60 percent debt-to-GDP ratio, he concluded that the rule “[being] far from golden, is a poor one that does not correspond to either of the principles of good fiscal policy—it cannot guide an economy towards a moderate and sustainable level of public debt and it cannot keep public debt fluctuating around this moderate level in a countercyclical fashion.”

Whelan puts forth the following argument: If the rule on long-run debt levels is followed, it will lead to debt ratios that fall well below those considered sustainable and moderate. An

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8 Quentil Peel, Germany's judgement day, Financial times, August 8, p.5.
economy's debt-to-GDP ratio tends to converge toward the ratio of the average deficit percentage to the average growth rate of nominal GDP. As such, Whelan calculates that an economy with an average growth rate of a nominal GDP of 4 percent following a policy in which average deficits are a maximum of 1 percent will end up with a maximum debt-to-GDP ratio of 25 percent—far below what is required to operate a sensible and stabilizing fiscal policy.\(^{10}\)

In addition, Whelan’s analysis of following the rules stipulated by the Fiscal compact for stabilization purposes shows their overly restrictive nature: The 3 percent maximum deficit rule severely limits the ability to run countercyclical policies of this type that would still be consistent with moderate levels of debt.\(^{11}\)

Using his analytics of the debt-to-GDP ratio, Whelan pointed out that the Fiscal compact resembles the golden straitjacket—reminding us of the grave consequences of the rigidity of the gold standard in the 1930s—more than the truly productive and feasible golden rule for the EU member states. He is convinced that the Fiscal compact was not carefully designed and was probably developed in haste, as often evident in the EU decision-making processes in the past; if not carefully revised, it may have long-term negative consequences for the European economies and societies. We are of the opinion that such serious claims and arguments cannot and should not be ignored by the European technocracy. To force EU countries to run unified fiscal policies based on theoretically flawed prescriptions sounds like a true recipe for disaster.

The European Macro Group—three European macroeconomic institutes: IMK from Düsseldorf, WIFO from Vienna and OFCD from Paris—prepared a joint study on the impact of austerity measures, reinforced by the Fiscal compact. Their findings are important and unambiguous. The current direction of the EU focused on austerity measures across the board and was reinforced with the newly adopted, albeit not yet fully implemented, fiscal rules. The analysis and assessment of the macro group is even more ominous: The combination of tough austerity measures across the EU, further strengthened by the fiscal rules, is likely to push

\(^{10}\) Ibid.

\(^{11}\) Ibid. His calculation is as follows: “For example, a deficit of 2.4 percent per year would, over time, stabilise the debt-GDP ratio at 60 percent in an economy in which nominal GDP grew at an average 4 percent pace. Cyclical deviations of 2 or 3 percentage points around such an average deficit of 2.4 percent would also be possible without endangering fiscal stability. However, the 3 percent maximum deficit rule severely limits the ability to run countercyclical policies of this type that would still be consistent with moderate levels of debt.”
large parts of the EU into a new recession in the near future. The outlook of most of the EU countries, including core countries, is not optimistic.

The European Macro Group provided further analysis of the adopted Fiscal compact—namely, the requirement to balance the budgets or secure their surplus and ensure that the structural deficits will remain below 0.5 percent of gross domestic product, with the European Court of Justice empowered to verify whether this rule is obeyed, is deeply questionable. Countries exhibiting deficits will have to reduce them rapidly; countries whose debt ratio exceeds 60 percent will have to reduce the excess debt by 5 percent per year. In addition, budgetary plans and structural reforms will have to be approved by the European Commission and the Council.

The European Macro Group concluded that the fiscal pact is macroeconomically dangerous and imposes budgetary rules on the countries based on arbitrary figures. Automatic policy measures introduced by the fiscal compact mean that the countries will not only have to abstain from anti-cyclical policies, but will also have to adopt pro-cyclical measures. The mere control of numerical figures is not the same as true economic coordination. The Fiscal compact is not consistent with sensible European economic policies and is heading in the wrong direction.

The European Macro Group’s joint study reminds us of the arbitrariness of the target of a debt ratio of 60 percent. This figure was invented as part of the Maastricht criteria and was justified under the assumption that a nominal GDP would grow by 5 percent per annum in the medium to long run.12

The fundamental flaw of the debt criterion of the Fiscal compact according to the European Macro Group’s study is that no differentiation exists between government debt accumulated for cyclical reasons and government debt accumulated for other (“structural”) reasons.13

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12 In this case, the government ratio converges toward 60 percent even if the budget deficit permanently reaches the Maastricht limit of 3 percent. In reality, the nominal GDP of 11 countries has increased by only 3.5 percent per year since 1992. This fact would require significant changes of the targets—a maximum target for the government debt ratio of about 86 percent. Moreover, if the overall deficit is to be limited to 0.5 percent, countries such as Italy would have to reduce their public debt by 5.3 percentage points of the GDP per year for 20 years. IMK (Düsseldorf), OFCE (Paris) and WIFO (Vienna): Fiscal Pact Deepens Euro Crisis—joint analysis of the Macro Group. <www.boeckler.de/pdf/p_imk_report_71e_2012.pdf> (March 2012), pp. 20-23.

13 Ibid., p. 20.
According to the European Macro Group, the only sensible way out of this macroeconomically dangerous Fiscal compact, which may further dampen economic prospects in the Eurozone, is to move away from the (arbitrarily) determined numerical limits toward an improved quality of member states’ fiscal policies. This can be obviously achieved in far less intrusive ways for the member states that are struggling with the biggest economic, financial and social crisis since the foundation of the EU. Not surprisingly, scholars from the EU country suffering from depression-like levels of unemployment concluded that the Fiscal compact is “the most unbalanced and asymmetric treaty member states have ever signed, is the best illustration of the new Europe: while austerity is strictly enforced, growth is barely promised.”

Thus far, we have presented economic contradictions of the Fiscal compact. Equally worrisome are some of the theoretical assumptions of the Fiscal compact. Paul de Grauwe, one of the leading scholars of EU monetary integration, pointed out that the balanced budget rule is based on the cynical view of what governments do. The rule implies that the governments do best when they do preferably nothing and leave it to the markets to do the job:

There is no sound economic reason to back up such a rule. Governments invest in infrastructure, human capital, the environment, and the law and order. All these investments increase the productive capacity of a nation. There is no reason for governments to be prohibited from issuing debt to finance these investments. In much the same way as there is no reason to prohibit firms that invest productively to issue debt. In fact, economic theory tells us that governments that invest productively should issue debt to finance these investments. Productive investments profit present and future generations. It is therefore desirable to spread the cost of these investments over present and future generations…. What should be avoided is unsustainable debt, not debt per se.

The Fiscal compact, in combination with synchronized austerity measures, has contributed to the EU’s recession and long-term stagnation and has not brought about improvements to the quality of fiscal policies across the EU. It is poorly designed, with many internal contradictions, and will inevitably become a source of new conflicts and divisions in the EU.

16 The vast majority of the content of the Fiscal compact only reproduces already existing provisions of the EU Treaties or secondary legislation such as Stability and Growth Pact and the »Six pack« from November 2011.
As such, it is closer to the economic philosophy put forth by Herbert Hoover and his idea of liquidating the “rottenness” from the markets.

However, this does not mean that many of the EU countries in the past decade have not committed numerous mistakes in the public and private sector; rather, the ongoing EU response to the crisis, based on single-minded austerity and balanced budget, has further exacerbated the crisis. Many other crucial debates, such as how to reestablish links between local financial institutions and local business developments, how to address the EU’s persistent current account balance and many other crucial strategic issues, are being ignored due to the EU’s persistence in its austerity and balanced budget. It is a sign of a profound lack of ideas, initiatives and imagination, where the public discourse on how to move further in the EU is decisively missing.

3. Wrong diagnosis of public financial difficulties

Having provided an overview of the problems caused by the implementation of the Fiscal compact in the EU and referred to the equally problematic theoretical assumptions of the Fiscal compact, we now explore the reasons why the European leaders decided in the midst of the most severe financial, economic and social crisis to start disciplining and penalizing governments for their supposed profligacy. The reason stems from the diagnosis that the public financial difficulties, public debts and deficits are the consequence of the profligacy of governments prior to the financial crisis. There may have been elements of profligacy, to be sure. However, a more nuanced analysis of the last decade shows that all of the governments, with the exception of Greece, were disciplined with respect to public finances.

Based on various sources, Paul de Grauwe made the following observation: “While the government debt ratio in the Eurozone declined from 72 percent in 1999 to 67 percent in 2007) the household debt increased from 52 percent to 70 percent of GDP during the same period. Financial institutions increased their debt from less than 200 percent of GDP to more than 250 percent.”

Therefore, the Eurozone governments (with the exception of Greece) were more disciplined prior to the crisis than the private sector, and the explosion of the

government debt after 2007 was the result of the need to save the private sector—particularly the financial sector.\textsuperscript{18}

The wrong or at least partial or one-sided diagnosis of the root causes of the financial and economic crisis in the EU led to partial, one-sided measures being used to cope with the crisis across the EU. The EU insisted on a one-size-fits-all approach, being imposed from the top down to all member states and their regions. The approach to the crisis never carefully examined the role of large European financial institutions and how they escaped the necessary supervision of the European financial markets. If there were peripheral governments, excessively and irresponsibly borrowing, than there were large financial institutions on the other side that, in a similarly irresponsibly way, continued lending to over-indebted governments.

The debate and analysis about the large and small European financial institutions purchasing huge amounts of toxic assets on the other side of the Atlantic is an additional puzzle piece in the missing debate on the role, importance and supervision of the financial institutions. Was not the idea of the single market in the financial sector to be an instrument to channel financial resources across Europe in the most efficient and rational manner? If so, why have such large quantities of European savings ended up via European financial institutions in the American toxic assets? What the EU citizens need is a more transparent, objective and comprehensive analysis of the role of European financial institutions if we are ever to move beyond the crisis toward more sustainable, transparent and balanced European economies and societies.

Fallen revenues due to the recession, increased unemployment benefits and recapitalization of the financial institutions are among the main reasons for the deteriorating public financial position of the European governments. The fiscal trap of many European governments is a

\textsuperscript{18} “Those who say that it is government profligacy, that is the source of the debt crisis are mistaken. They also fail to see the inevitable connection between private and public debt. This connection is particularly strong in countries like Spain and Ireland that have been hit badly by the debt crisis. As can be seen from Figure 2, Spain and Ireland were spectacularly successful in reducing their government debt to GDP ratios prior to the financial crisis—namely, Spain from 60 percent to 40 percent and Ireland from 43 percent to 23 percent. These were the two countries that followed the rules of the Stability and Growth Pact better than any other country—certainly better than Germany, which allowed its government debt ratio to increase before 2007. Yet the two countries, which followed the fire code regulations most scrupulously were hit by the fire because they failed to contain domestic private debt.”
consequence—not a cause—of the financial crisis. It should be recognized and managed accordingly, not perceived as a main culprit and cause of the crisis.

Charles Wyplosz recommended a more decentralized approach to the fiscal consolidation.\(^\text{19}\) Such a decentralized approach toward fiscal consolidation would be capable of taking into account the variety of macroeconomic situations in which different member states find themselves, thereby facilitating a much larger autonomy and larger maneuvering room for the member states and, subsequently, greater responsibility among the member states. Yet such an approach presupposes much stronger trust and credibility among the member states and potentially risks moral hazards. No one can deny that such a risk truly exists. Without the existing mutual trust and credibility among the member states and their governments, irrespective of their political structure, it is not possible to foresee a stable and sustainable union. To replace it with the previously discussed forced measures, reinforced by serious penalties, the union would most likely not be able to function successfully either. The founding fathers of the EU understood this paradox much better than the current generation of European leaders and technocrats.

In addition to the discussion on the right diagnosis of the root causes underlying European imbalances and weak democratic accountability at the supranational—and often at the national—levels, an additional characteristic of the crisis and deep recession exists but has been overlooked. Such a phenomenon was widely analyzed and understood in previous crises (e.g., the Great Depression). Namely, all of the European economies are experiencing an ongoing complex process of deleveraging the public sector, households and companies. Irwing Fisher noted during the Great Depression that it is not possible to achieve a deleveraging of both the public and private sectors simultaneously. Attempts to deleverage both sectors simultaneously can damage the economy as a whole. The private sector can only reduce its debt if the government is willing to increase its own debt. Otherwise, negative dynamics are created that can pull the economy down into deflation. In the literature, this phenomenon is known as the Fisher paradox.\(^\text{20}\)

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\(^{20}\) For more on the relation between the Fisher paradox and the poorly designed process of deleveraging across Europe, see Paul de Grauwe, ‘Crisis in the eurozone and how do deal with it’, CEPS Polic Brief, no. 204/February 2010: <www.ceps.eu/ceps/download/2928> p. 2.
4. The false idea of expansionary austerity

The next argument in favor of adopting the Fiscal compact stems from the conviction that the best solution to the public financial crisis and recovery is the implementation of austerity measures. Tough austerity measures would calm the financial markets and investors because new stability would be established, encouraging new investments due to the reduced risks in the markets.

Such an assumption about establishing the market and investors’ confidence is based on tough austerity measures. Austerity measures are usually accompanied by other measures—most notably, structural reforms that include the labor market reform in the direction of further flexibility of the labor market, liberalization of the European market of products and services and other measures of market liberalization. Among member states that are still making efforts to preserve the remaining parts of the welfare protection for employees, structural reforms generally present the last measures in reducing the labor unit costs: the reduction of the remaining standards of social safety in the case of unemployment, medical, health, pension and other welfare protections.

The problem with the assumption about newly established confidence based on expansionary austerity is that it has very little support in empirical studies to date. The general effect of the measures across Europe is that the budget deficits do not decrease fast enough to prevent the deterioration of the debt-to-GDP ratio because the GPD is falling faster than the public debt. In this context, austerity measures do not establish the necessary confidence of the financial markets, but rather further undermine confidence. The answer of the European leaders in this context is that we need more austerity instead of measures and policies to stimulate jobs and growth. This economic philosophy again resembles Hoover’s economic philosophy. Despite the empirical fact that the European policy is pushing more and more member states and their regions into a deep recession, resulting in high levels of unemployment, especially among the youth, European economic policies remain largely unchanged.

Empirical studies indicating that expansionary austerity has a very poor record remain ignored. A comprehensive study by the IMF, conducted on 173 case studies of austerity measures in 17 developed countries in the preceding 30 years aimed at financial consolidation
with the help of tough austerity measures, clearly highlighted this misunderstanding. The findings are once again unambiguous: Countries that try to cut the expenditures too soon and too deeply increase unemployment—both short and long term—and reduce incomes, especially for the lowest income social groups.21

Short-term effects of tough austerity measures are negative in contrast with the declared expectations of the European leaders. They negatively affect demand and economic growth. Based on these empirical facts and extensive research, IMF director Christine Lagarde, a former French finance minister, warned her former colleagues—namely, the European finance ministers—that slamming on the fiscal brakes too strongly might have negative impacts on the employment outlook and general economic recovery.22 More important than implementing one-sided and unbalanced measures is the need to try to achieve fiscal consolidation in the medium run while simultaneously carrying out incentives to achieve economic growth and jobs.

Kenneth Rogoff and Carmen Reinhardt demonstrated that growth in the time of debt has no simple causal links as often presented in the context of European decision-making processes. For example, they concluded that the relationship between government debt and real GDP growth is weak for debt/GDP ratios below a threshold of 90 percent of the GDP.23 No one is trying to claim that debt burden (public, private, domestic, foreign) is unimportant. The argument is much more subtle: Debt thresholds are country specific; where the “debt intolerance” begins is a much more contextual matter. Therefore, approaching the fiscal consolidation on a more decentralized and medium-term basis, where other important macroeconomic aggregates and circumstances are taken into account, sounds like a more consistent approach to the crisis than the one-size-fits-all approach currently adopted in the EU.

The impression is that the European leaders encountered the financial and economic crisis unprepared. More often than not, they adopted the decisions in haste and under the huge pressure of the crisis unfolding before them. It may well be that the European institutional

structure was unprepared for a crisis of such magnitude, but the decisions made by the European leaders as well as the decisions not made by them undoubtedly further exacerbated the crisis. In this sense, the Fiscal compact presents only the tip of the iceberg. The EU economic policy and the economic policies of the member states need substantial redirection toward comprehensive institutional restructuring and economic and social reconstruction.

It is difficult to understand and explain why European leaders are unwilling to adhere to these more subtle recommendations. It is perhaps due to the superficial analysis of the nature and extent of the crisis or the misperception that the crisis is not only financial but also related to the real economy in the majority of the European regions. The weak and largely ill-conceived response to the crisis can also reflect the EU democratic deficit, which means that a large part of the European population remains excluded from the discussions, unable to articulate their ideas and initiatives or express their concerns and needs. This is the point where the weak development of the European constitutional democracy comes in with full importance.

5. Poor understanding of the role and importance of public debt

Advocates of fiscal realism, in the absence of strong normative, doctrinal and empirical arguments, prefer to use a very simplistic but seemingly convincing household logic: What holds for households also holds for national economies. However, they tend to forget that the national economy consists of many households in different situations. Some households are saving while others are taking out loans for various purposes. The same is true for other actors in the national economies: Some companies invest and grow, start-up companies take on debts to develop, and others are saving their corporate profits. Thus, to take the household logic to the aggregate level is misleading.

Paul Krugman conducted a historic analysis of the British public debt, pointing out that British public debt exceeded 100 percent of the country’s GDP in 81 of the last 170 years.24 High levels of debts during various historic periods did not prevent Britain from developing and growing nor from repaying all of its commitments; they certainly did not prevent Britain from international financial markets. Of course, as the leading economic power at the end of the nineteenth century and one of the leading financial centers in the world, Britain has held a very privileged position. On the other hand, it shows that there

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is no simple metric for determining the threshold tolerance of debt for different countries. If the balanced budget rule would have been a panacea for all macroeconomic challenges, countries such as Great Britain or the United States—as prime examples of the free market economy—would have enshrined such a rule into their legislative and constitutional contexts, respectively.

Attempts have been made in the United States to incorporate the balanced budget rule into the federal constitution, but they have failed. The reason for such failures is partly the positive experience with the New Deal period of the active federal approach to the Great Depression in the form of industrial recovery programs as well as the creation of the social safety net and partly due to the pragmatic reasons for not limiting the government’s maneuvering room during economic crises. Although many of the state constitutions in the United States have incorporated the balanced budget rule, this is not the case at the federal level. The federal budget, dedicated to key social programs such as Social Security, Medicare and Medicaid, together with defense and homeland security, represents 18 percent of the GNP. During a period of crisis, the United States even extended health insurance to a large part of the previously uninsured population. The EU budget, on the other hand, with little more than 1 percent of the EU’s GDP, does not include any comprehensive social, educational or other development programs. All these programs remain the responsibility of the individual member states. To impose a balanced budget rule during an extensive economic, financial and social crisis would indeed amount to a fiscal straitjacket, making it not too difficult to foresee the social consequences.

The issue of the public debt, public assets, deficits and public finances is in truth a much more complex issue than recognized by the Fiscal compact. This is particularly evident in the historic example of the United States, which emerged from World War II with a high level of public debt. This high public debt did not present an additional burden for the taxpayers because of the high growth rates and subsequent high tax revenues. According to Krugman, the debt from the war was never repaid, it just became increasingly irrelevant as the American economy grew and, with it, the income subject to taxation. As long as the government can ensure that the tax base grows faster than debt, the debt remains in control. Of course this does not mean that the debt does not matter. It does. Yet Krugman reminds us that other things matter more. He is convinced that we need more, not less, spending for the United
States to escape its unemployment trap. The ill-informed obsession with debt stands in the way of recovery not only in the United States, but also—or even more so—in the EU.\textsuperscript{25}

Robert Heilbroner and Peter Bernstein have even shown that, “as long as growth continues and the debt remains in the same relation to GNP, there is no reason that a national debt cannot increase indefinitely.”\textsuperscript{26} In other words, public debt and deficits are not something bad in themselves; they do not present a burden for future generations if they are well managed and sustainable over the long term. The qualified discussion in the leading economy has shown that public debts are an integral part of modern democratic societies. They represent one of the instruments for securing the long-term development of societies. As long as total output grows, the public debt can also grow steadily because it serves the purposes connected with growth. If issues such as the structure of production, development of international economy, the careful design of the tax and expenditure structures are dealt with carefully and deliberately, then the issue of debt burden can be also dealt with successfully. In such a case, public debts and deficits are not part of the problem; they are part of the solution.\textsuperscript{27}

Opting for public debt is sensible and justified because the public sphere, similar to the private sphere, contributes to economic growth. Public investments can even make a vital contribution to the economic development inasmuch they provide the necessary and adequate infrastructure, provide investments in education and training and support and participate in overall social development.\textsuperscript{28} Economic growth and social development would suffer if modern societies were unable to provide resources for public investments.

The United States is a country with a long history of comprehensive data on the public and private sectors. A study by David Aschauer of the Chicago Federal Reserve from the 1980s—the period of Reagonomics—concluded that the productivity of public investments exceeded that of private investments. The costs, imposed on the private sector by an inadequate infrastructure, were so great that the study concluded that private profitability would have risen by two percentage points if non-defense public investment were to rise from its present

\textsuperscript{25} Ibid. See also P. Krugman, \textit{End This Depression Now}, W. W. Norton & Company 2012, particularly chapters 10–13.
\textsuperscript{27} Ibid., pp. 53-54.
\textsuperscript{28} Ibid., p. 61.
low levels to the earlier levels.²⁹ Of course, such findings do not directly apply to many of the EU countries and regions, but they do suggest the need to pause for a second before cutting public investments on behalf of indiscriminatory austerity measures.

Two other important questions have emerged with respect to the issue of public debts and deficits and the often-mentioned arguments. These questions relate to the crowding out effect and the living beyond our means argument. The crowding out effect relates to the argument that the overly extensive amount of public spending and public investments suppresses private economic activity and private investments, thereby reducing the overall well-being of society. Similarly, the living beyond our means argument states that the government should not be incurring public debts so as not to disproportionately burden future generations.

If the crowding out argument holds, we would expect the countries with the worst public performance to show the largest rise in interest rates while the countries with the best public debt performance would show the smallest rise. Yet an empirical study of seven industrial countries ranked by increases in public debt and real interest rates in government bonds indicated that no significant correlation existed between interest rate changes and growth in public debt. Other important factors that are not fixed affected the identified relationship, such as domestic saving rates, balance of trade and monetary policy. As this study demonstrated, relating public debt to interest is a much more complex and mutually dependent issue than the proponents of the crowding out effect claim.³⁰

The debate on the crowding out effect carries with it another important dimension—namely, the dilemma put forward by Heilbroner and Bernstein: Should private spending always have priority over public spending? Some public investments with small initial return provide very positive effects for the national economy while some investments with vast profits have no positive effects on the national economy. This debate is connected with the importance and role of the public sector and with a broader debate on the overall national strategies of development.³¹ Of course, no one is claiming that there cannot be failed public and/or private investments as we can encounter them in both developed and developing parts of the world.

²⁹ Ibid., p. 61.
³⁰ Ibid., pp. 102-106.
³¹ Ibid., pp. 106-107.
The argument of living beyond our means is similar to the crowding out effect. This argument applies to a country that does not generate enough savings to be able to support its own capital investment.\textsuperscript{32} In the United States, which is well known for its “twin deficits”—budget deficit and trade deficit—the balancing of the budget would improve the shortage of savings only on the unlikely supposition that consumers and business firms made absolutely no changes in their decisions to spend, save and invest despite lower government revenues and higher taxes. In other situations, the economic growth would suffer even more than in the case of cutting back the private needs due to the failure to provide for public capital needs.\textsuperscript{33} This is the reason why Heilbroner and Bernstein recommended an increase of public investments financed by borrowing: A deficit used for public capital formation is the best way to raise household and business income and, as a result, their savings. Deficits used for investment do not “absorb” savings, but rather generate savings.\textsuperscript{34}

This discussion of the public debt and deficit in terms of public and private investments and savings in the American context illustrates the complex relation between the public and private sectors and between the government and the market. The discussion indicates that it is not possible to simply determine in advance certain numerical limits that define sustainable public debt and deficit as well as positive and negative consequences for the economy and society.

The risk of unsustainable public finance cannot be underestimated. For small, open economies sharing the fate of the common monetary area, such a caution is even more necessary. However, such awareness does not mean that we should indiscriminately, immediately and deeply cut public expenditures, especially growth-relating public expenditures. Quality of financial cuts matters more than quantity. This is often forgotten in the European context and further reinforced with the numerical limits determined by the Fiscal compact and other fiscal rules. These rules are too intrusive; they go too far and are part of the problem, not part of the solution for high-quality and transparent fiscal policy. It would be economically and socially unacceptable to cut investments that support growth, employment and all other forms of more inclusive, more balanced future developments. Some of the most competitive European

\textsuperscript{32} Ibid., p. 117.
\textsuperscript{33} Ibid., p. 120.
\textsuperscript{34} Ibid., p. 127.
societies and regions also maintain the highest levels of social cohesiveness.\textsuperscript{35} Competitiveness and social cohesiveness go hand in hand. This is of equal importance in the context of achieving a high-quality and sustainable system of public finance.

6. Legal issues of the Fiscal compact

So far we have argued that the Fiscal compact constitutionalizes a wrong economic policy. In this section we try to show that it is also deficient from a legal perspective.

From the procedural perspective, the Fiscal compact substantially deviates from the established path of European decision-making processes and brings along with it many dangerous precedents. Instead of using an ordinary revision procedure for the amendment (Article 48 of TEU) or enhanced cooperation as provided for in Article 20 TEU and in Articles 326 to 334 of the TFEU, it was adopted outside the EU law, as a separate international treaty. As a consequence, it could bypass more democratic and transparent procedure as provided for in the EU law and with it the participation of the European Parliament and the national parliaments. For example, according to the Fiscal compact, it shall enter into force when ratified by 12 out of 17 members of the euro zone, which deviates from the established consensual principles among the member states. True, the consensual principle may be very cumbersome and sometimes an almost impossible barrier to overcome when trying to adopt certain crucial decisions. However, to adopt such a deeply problematic fiscal compact outside the established European procedures might prove to be even more self-defeating.

It comes as no surprise that a growing number of European citizens are becoming suspicious of the Fiscal compact, particularly as the combination of tough austerity measures re-enforced by the Fiscal compact bring about economic and social disasters in countries such as Spain, with its unemployment reaching a depression-level state. The lack of democratic legitimacy in adopting the Fiscal compact is obvious and can further undermine the legitimate intentions to create a system of sustainable public finance across the EU. The Fiscal compact requires

\textsuperscript{35} This is only one of the reasons why European scholars suggest the need to revise the fiscal compact in such a way to omit growth-enhancing investments in infrastructure projects, education, research and development from the balance sheets. See Vivien Schmidt, ‘Europe 2012: The devil is in the details’, BEPA Monthly Brief, January 2012, p. 3.
broad public debate among member states because it affects all of the citizens—probably more so than any other EU treaty and/or European measures thus far. The idea of imposing such a treaty from the top down, without any open, transparent or productive public discussion, only illustrates the poor development of constitutional democracy in Europe. It is one of the reasons why the Fiscal compact is becoming so unpopular among the European citizens, not only on periphery, but also in the core EU countries. The European constitutional project, unfinished and stalled in the process, certainly requires much broader pan-European debates about the future direction of the European project. Initially, only Ireland put the Fiscal compact on the referendum because of the requirements of the Irish constitution.36 Now, the Dutch socialists are also demanding a referendum in Netherlands. And there is a possibility of referendum in Germany as a consequence of the expected ruling of the German Constitutional Court.

But even more problematic are substantive legal aspects of the Fiscal compact. As mentioned in the Introduction, it basically entrenches a certain economic theory at the level of constitutional law requiring the signatories of the pact to change their constitutions, preferably, with new provisions “of binding force and permanent character”.37 In other words, the signatories of the compact are asked to introduce into their constitutions provisions which can’t be changed through regular amendment procedures. As a consequence, the austerity policy of Angela Merkel thus achieves binding and eternal legal validity. Once thought to be a quintessential domain of the executive, economic policy now becomes a matter of constitutional law where major players with extensive power of control and sanction are not national parliaments or governments, but supranational technocracy and judges. The Fiscal compact essentially empowers technocrats and judges to decide whether the member states fiscal policies are in compliance with internationally imposed rules of balanced budgets and other fiscal commitments contained in the Fiscal compact. Once a country is found in breach of these fiscal obligations, both the Commission and the Council have extensive powers of control and sanction over a member state fiscal policy. As argued by a prominent economist, - “the profoundly undemocratic nature this approach is clear- the unelected European Commission can “request” that the elected national parliament and government to change its

36 Irish people voted for the compact, but, as many commentators suggested, with a gun to their heads. Namely, recital 25 of the Fiscal compact makes access to financial assistance from the European Stability Mechanism conditional on the ratification of the compact.
37 Article 3, paragraph 2 of the Fiscal compact.
budget.” 38 No surprise then that in the editorial, one of the leading constitutional journals in Europe concludes that the Fiscal compact “strikes at the heart of the institutions of parliamentary democracy by dislocating as a matter of constitutional principle the budgetary autonomy of the member states.” 39 In addition, the European Court of Justice was given new powers to determine whether the member states comply with their duty to introduce balanced budget rules into their constitutional legal order. Such new power represents “unprecedented constitutional intrusion”, 40 since the European Court of Justice never had the power to interpret national constitutions of the member states.

The Fiscal compact has brought not only a deep intrusion into the fiscal maneuvering room of the member states. It is also too rigid and too restrictive in terms of its budgetary and fiscal rules. Although many of its rules are ambiguous, that does not solve the problem of rigidity of its main “targets”: i.e rules on allowed structural budget deficit and public debt. As the IMK study shows, few of the EU countries undergoing severe economic crisis would be able to implement these rules without seriously undermining its prospects for future economic growth.

From the perspective of comparative constitutional law the Fiscal compact opens another important constitutional issue: is constitution appropriate place to entrench a particular economic ideology or policy? As Justice Holmes argued in his famous Lochner dissent, people in democracy have different, often opposing views on economic policy. It would therefore be wrong to entrench one particular economic ideology/policy in the constitution. In Hollande’s opposition to transpose the Fiscal compact into the French constitution, we can clearly see the echo of Holmes’s argument. Hollande’s argument was that the constitution is a lasting document which should not be used for a short term policy objectives. As a result, France announced that it will transpose the golden rule of balanced budget into their organic law. Several other countries debate whether to include the golden rule into their constitution or legislation. Such a decision is part of the constitutional and institutional tradition of each of the countries, and there can be no universal proscription as to what and when to include or exclude from the constitutions. To include certain economic doctrine at the constitutional

40 Ian Cooper, Nine Pro-European Reasons to Oppose the Fiscal Treaty, supra, note 2.
level may shrink the space for constitutional pluralism and democratic deliberation processes. It may lead to the impoverishment of the public discourse on alternative possibilities and impoverish the level of constitutional democracy.

It is indicative that committed and able Europeans, such as Jacques Delors, fiercely criticize the fiscal compact. For lawyers, it is also very indicative that some of the leading European legal experts, such as Jean-Claude Piris, have expressed their doubts. Piris, the former director general of the EU Council’s legal service who helped pen the Maastricht, Amsterdam, Nice, Constitutional Treaty and Lisbon treaties, referred to the EU’s new fiscal compact as a “little piece of paper” and “a treaty outside a treaty” that could not stop the financial crisis. He has also mentioned that the austerity measures have a limited reach. He recommended that the national parliaments have a greater say in addressing the European financial and economic crises to ensure democratic legitimacy.41

7. Conclusion: Alternative proposals

In light of the critical analysis of the fiscal compact, questions about the possible alternatives to the European fiscal compact, austerity measures and occasional ECB interventions should be discussed. We are of the opinion that credible alternatives do exist.

During the past three years, the EU and its member states have been dealing with the crisis in a way that can be summarized as follows: Austerity measures were adopted and imposed throughout the EU countries, irrespective of their fiscal, economic and financial position before the crisis; austerity measures were reinforced with the adoption of the fiscal compact, which presupposes one single model of fiscal consolidation across the EU, particularly in the Eurozone; bail-outs for certain peripheral countries, such as Greece, Ireland, and Portugal were adopted under strict conditions determined by the “troika”; and occasional interventions by the ECB took place, such as the lending scheme with very low interest rates in the amount of one trillion euros between December 2011 and February 2012.

Despite these measures, EU economies and societies have not been able to return to the path of economic, financial and social recovery. Indeed, the fiscal positions of many member states

have actually deteriorated because their GDPs fell even more rapidly than they were able to reduce their public debt. The Eurozone and EU are experiencing the highest levels of unemployment in their histories, and the outlook for the labor market remains bleak.

The EU could and should do better than that. First and foremost, the fiscal compact rules should be tailored less rigidly. The approach to fiscal consolidation should be implemented in a more decentralized way. It should be pursued as a medium-term goal and in close relation to economic recovery based on socially inclusive growth in each of the member states. The critics of the decentralized approach toward fiscal consolidation would undoubtedly reject such an approach based on member state governments’ lack of credibility in sticking to identified goals. Yet mutual trust and credibility are vital elements of any integration and any coordination of economic, social and political matters. We are of the opinion that the member states and their governments are in principal trustworthy partners. Moreover, in order to successfully pursue fiscal consolidation, the participation of social partners, local and regional governments, and independent civil society is crucial as all of them have stakes in the process of fiscal consolidation. As such, fiscal consolidation should be implemented using a more decentralized approach.

Instead of one single model of fiscal consolidation, pursued from the top down and on the basis of a one-size-fits-all approach, we should apply a more differentiated and nuanced approach. It may appear to be a more complicated model, but it may be better suited for different fiscal, financial and other social characteristics of each of the member states. Establishing public trust and transparency when pursuing fiscal consolidation is more important than creating and following clear-cut rules of fiscal consolidation. Sweden’s successful fiscal consolidation provides an example of how fiscal consolidation can be achieved based on fiscal transparency and high-quality economic policy debate. According to the chair of the Swedish Fiscal Policy Council Lars Calmfors, this is more important for budget discipline than formally binding rules and automatic correction mechanisms as envisaged in the European fiscal compact.42

If advocates of the fiscal compact want to ensure that the fiscal rules do not negatively impact economic growth, they should consider excluding growth-enhancing investments, such as

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investments in public infrastructure, education, and research, training and development, from the rule on what counts toward the budget deficit.  

In addition to the substantially revised and improved rules on fiscal consolidation, the debate on the importance and role of financial institutions in the EU should follow. The inconvenient truth about Europe’s financial sector in its present form is that it has become bloated and dysfunctional. In its current form, it does not represent support for the real economy, but a drain on it. The understanding of the role of financial institutions is a crucial point of the European crisis debate. Propping up the entire European financial sector without questioning to what extent it is capable of supporting and lending to the real sector is highly problematic.

When the last banking loan scheme—in the amount of one trillion euros to the European banks—was launched by the ECB between December 2011 and February 2012, these banks used the new cheap loans mainly to purchase government bonds, retire or repay existing more expensive borrowings while surplus funds were redeposited with the ECB. There is no evidence to indicate the extent of these funds being channeled into investments in the real economy. By propping up the financial sector, we are unfortunately not helping the real economy. The key lesson of the financial crisis—overlooked and ignored by the European and national policymakers—was succinctly put forward by Dirk Bezemer:

…most of that debt growth has NOT been due to lending to the real sector—to nonfinancial firms, supporting growth in wages and profit. Almost all of it was due to mortgage lending and to credit to the nonbank financial sector credit, to inflate stocks and property prices and to create and trade options, futures, and other derivative instruments….  

The distinction between the socially useful financial activities and trading activities within the financial sector, both banking and non-banking, deserves more attention. Contrary to conventional wisdom, money used for the exchange of positions between financial

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institutions provides very little and only episodic links with the real economy. Short-term portfolio investments have dominated long-term investments in productive capacities.

Thus, the real challenge for policymakers is determining how to re-establish links between the financial institutions and the real economy. In its current form, financial institutions present very little importance for the real economy in good economic times; during periods of financial crisis, they represent a threat to the real economy and society at large. The challenge is to restructure financial institutions in such a way as to turn them from bad masters to good servants to provide the necessary support for economic and social activities. Small local and regional networks of banks are generally more supportive of local and regional economic development than large concentrations of finance. Any rescue of the financial sector should be carried out only to the extent that these financial intuitions can provide long-term capital for the productive investments. New financial institutions capable of tightening the links between savings and productive investments can be envisaged, including public venture capital funds.45

Revising the rules of the fiscal compact and restructuring the financial sector are only small parts of the genuine economic and social reconstruction in the EU context. Future EU development should stimulate and support more initiatives stemming from the local, regional and national levels. The EU should support more diverse, balanced and inclusive development.

In this context, the debate on what should be decided at the common EU level, what should be the EU’s common policies and what should be left to the member states could be significantly reoriented. At the core of the EU’s common policy should be EU support for lifelong education to empower individuals and equip them with the necessary skills and capacities to participate actively in knowledge-based economies and societies. Maximum maneuvering room for more innovative economic and institutional policies should be retained for the member states. Parliamentary democracy can develop when the national parliaments can articulate and implement different strategies for socially inclusive growth. More policy space is necessary at all levels of EU polity.

Finally, if countless billions were found for propping up large European financial institutions, it would be equally helpful to find a small fraction of this money for the support of education and research, as well to retrain and reskill European citizens.

The EU is not lacking financial resources, but rather ideas about how to create more inclusive, diverse and pluralistic European societies and economies. The future of the EU will be determined by the ability of the European civil society to articulate and push forward alternative possibilities and alternative futures.