The Constitutional Boundaries of European Fiscal Federalism

A Study of Public Finance Governance in the European Economic and Monetary Union

Brady P. Gordon B.A., LL.B., LL.M, Ph.D

School of Law
Trinity College, the University of Dublin
Declaration

This thesis has not been submitted as an exercise for a degree at this or any other university.

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Date: __________ 15 July 2017
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Summary

This study presents a systematic research agenda to identify the constitutional boundaries of European fiscal federalism, and determine which institutional models of fiscal federalism theory are theoretically and empirically compatible with the European legal order.

The first principal task of this research undertaking is to identify the constitutional boundaries of fiscal federalism that are integral to the stability of the European Union legal order as a whole. A constitutional boundary is defined in this thesis as an integral constitutional value or structure which cannot be conferred or amended by the national (or European) legislator under constitutional law; which prevents certain legal machineries of public economics from taking effect in the legal system; and so constitutes a permanent constraint on European fiscal federalism. In pursuance of that object, Part I (Chapters 1-4) of this study deploys a grounded theory methodology, by which the analysis pursues an hypothesis implicit in the data. Part I identifies two permanent constitutional boundaries of the EU legal order which constrain European fiscal federalism, de lege lata and de lege ferenda:

The first is fiscal sovereignty. This principle is impressed upon the allocation of competences in economic policy (Articles 2(3) and 5(1) TFEU) and the substantive provisions governing public finance (Articles 121-126 TFEU). Under those articles, economic policy remains completely outside the boundaries of the European legal order. Notwithstanding any amendment to the Treaties lex ferenda, this forms an immutable constitutional boundary of the European legal order. In so far as the limits of EU competence are governed by the principle of conferral, it can have no powers other than what the Member States have given it, and nemo plus iuris transire (ad alium) potest quam ipse habet, what the Member States have given it is limited by their own ‘constitutional identity’ jurisdictions. Not only has economic policy not been conferred on the Union, it cannot ever be so conferred without abrogating, inter alia, the Democratic State shielded by the ‘eternity clause’ (Articles 20 and 79(3)) of the German Basic Law. Numerous other constitutional courts have drawn similar boundaries around fiscal sovereignty.

The second is the fundamental guiding principles of price stability and fiscal discipline binding on the mandate for EMU under Articles 119-127 TFEU. According to the German Constitutional Court, the fundamental principles of the ‘Stabilitätsgemeinschaft’ (Stability Community) are ‘the basis and subject-matter of the German Act of Accession.’ A development contrary to that mandate would violate the conditions subject to which monetary policy was conferred, mandating Germany, at minimum, to withdraw from the monetary union.

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1 Brunner & EU Treaty (Germany) (Cases 2 BvR 2134/92 & 2159/92): BVerfGE 89, 155; [1994] 1 CMLR 57 [80]-[89].
The second principal task of this research is to define which institutional configurations of fiscal federalism theory remain compatible with the boundaries of the European legal order in this area of study. To that end, Part II (Chapters 5-8) deploys classical positivist methodologies using established legal precedent and empirical economic data for inputs. The analysis yields two constitutional criteria with which any model of European fiscal federalism must comply if it is to remain stable and permanent as a matter of law and economics:

First, any model of European fiscal federalism must preserve the fiscal sovereignty of the twenty-eight constitutional democracies which form the basis of its legal order. Specifically, any machineries of public economics must comply with the tests for democratic legitimation under Member State ‘constitutional identity’ and ‘ultra vires’ review jurisdictions or they will not take effect in the legal system, and will not be compatible with the European legal order. This study identifies and applies those tests to the EU fiscal governance architecture.

Second, hard budget constraints and market discipline are indispensable requirements for the fundamental guiding principles of price stability and fiscal discipline. Systems of fiscal federalism which substitute hard budget constraints for centralised legal governance are not compatible with the guiding principles of price stability and fiscal discipline, and are not compatible with the immutable constraints of fiscal sovereignty underlying the European legal order. In particular, the German Constitutional Court has held that the ‘no bailout’ and ‘no monetary financing’ rules safeguard the Bundestag’s ‘national budgetary responsibility,’ and Germany’s constitutional identity would be violated if the Stabilitätsgemeinschaft should become a ‘liability community’ through the ‘direct or indirect communitarisation of state debts.’

This study concludes that the European Union has embarked upon a model of ‘fiscal union’ that is manifestly incompatible with the European legal order. It concludes by offering a roster of specific amendments to defuse latent conflicts under existing legislation, and by specifying the criteria which European fiscal federalism must meet in order to remain stable and permanent as a matter of law and economics.

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2 Re Ratification of the ESM Treaty and Fiscal Compact I (Germany) (2 BvR 1390/12) (12 September 2012); [2013] 2 CMLR 3 Bundesverfassungsgericht (German Constitutional Court) [203], Re Ratification of the ESM Treaty and Fiscal Compact II (Germany) (Cases 2BvR 1390/12 et al) (18 March 2014); [2014] 2 CMLR 42 Bundesverfassungsgericht (German Constitutional Court) [167]-[171], Aid Measures for Greece and the Euro Rescue Package (Germany) (Joined Cases 2 BvR 987/10, 1485/10 & 1099/10): BVerfGE 129,124 (English version) Bundesverfassungsgericht (German Constitutional Court) [129], [137].
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<td>ACIR</td>
<td>Advisory Commission on Inter-governmental Relations</td>
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<td>AG</td>
<td>Advocate General</td>
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<td>AGS</td>
<td>Annual Growth Survey</td>
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<td>AMR</td>
<td>Alert Mechanism Report</td>
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<td>APP</td>
<td>Asset Purchase Programme</td>
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<td>ARRA</td>
<td>American Recovery and Reinvestment Act</td>
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<td>BBR</td>
<td>Balanced-budget rule</td>
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<td>BEPS</td>
<td>Broad economic policy guidelines</td>
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<td>BGLF</td>
<td>Bilateral Greek Loan Facility</td>
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<td>BIS</td>
<td>Bank for International Settlements</td>
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<td>BL</td>
<td>(German) Basic Law</td>
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<tr>
<td>BoG</td>
<td>(ESM) Board of Governors</td>
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<td>BoP</td>
<td>Balance of Payments</td>
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<td>bps</td>
<td>Basis points</td>
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<td>BVerfGE</td>
<td>Bundesverfassungsgericht (German Federal Constitutional Court)</td>
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<tr>
<td>CAC</td>
<td>Collective Action Clause</td>
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<td>CAP</td>
<td>Corrective Action Plan</td>
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<td>CAR</td>
<td>Capital Adequacy Ratio</td>
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<td>CEAA</td>
<td>Constitution of the Republic of Estonia Amendment Act</td>
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<tr>
<td>CJEU</td>
<td>Court of Justice of the European Union</td>
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<tr>
<td>CoG</td>
<td>Committee of Governors of the Central Banks of the EEC</td>
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<td>CRD</td>
<td>Capital Adequacy Directive</td>
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<td>ECCL</td>
<td>Enhanced conditions credit line</td>
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<td>ECFIN</td>
<td>Directorate-General for Economic and Financial Affairs</td>
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<td>ECJ</td>
<td>European Court of Justice</td>
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<td>ECOFIN</td>
<td>Economic and Financial Affairs Council</td>
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<td>ECSC</td>
<td>European Coal and Steel Community</td>
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<td>ECU</td>
<td>European Currency Unit</td>
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<td>EDP</td>
<td>Excessive Deficit Procedure</td>
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<td>EESC</td>
<td>European Economic and Social Committee</td>
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<td>EFsf</td>
<td>European Financial Stability Facility</td>
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<td>EFSM</td>
<td>European Financial Stability Mechanism</td>
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<tr>
<td>EIB</td>
<td>European Investment Bank</td>
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<td>EIP</td>
<td>Excessive Imbalance Procedure</td>
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<tr>
<td>EMCF</td>
<td>European Monetary Cooperation Fund</td>
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<tr>
<td>EMS</td>
<td>European Monetary System</td>
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<tr>
<td>EMU</td>
<td>(European) Economic and Monetary Union</td>
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<tr>
<td>EPP</td>
<td>Economic Partnership Programme</td>
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<td>ERM</td>
<td>Exchange Rate Mechanism</td>
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<td>ESA</td>
<td>European System of Accounts</td>
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ESM European Stability Mechanism
ESRB European Systemic Risk Board
FGFF First Generation Fiscal Federalism
FPT Federal-Provincial Territorial Collaboration
GDP Gross Domestic Product
HTS Harmonised Technical Standard
IADB Inter-American Development Bank
IDR In-depth Review
IEO (IMF) Independent Evaluation Office
IGC (Maastricht) Inter-governmental Conference
IMF International Monetary Fund
ISB Independent Standards Body
MIP Macroeconomics Imbalance Procedure
MLSA Minimum linear structural adjustment
MoU Memorandum of Understanding
MSP Multilateral Surveillance Procedure
MTO Medium-Term Objective
NEER Nominal Effective Exchange Rate
NRP National Reform Programme
NSI National Statistical Institute
OCA Optimum Currency Area (theory)
OECD Organisation for Economic Co-operation and Development
OJ Official Journal (of the European Union)
OMC Open Method of Coordination
OMT Outright Monetary Transactions
PCCL Precautionary credit line
PIIGS Portugal, Ireland, Italy, Greece, Spain
PPP Public-private partnership
pps Percentage points
QMV Qualified Majority Vote
REER Real Effective Exchange Rate
RWA Risk-Weighted Assets
SCPs Stability and Convergence Programmes
SGFF Second Generation Fiscal Federalism
SGP Stability and Growth Pact
SMP Securities Markets Programmes
SPV Special-purpose vehicle
TFP Total Factor Productivity
TSCG Treaty on Stability, Convergence and Governance
VfGH Verfassungsgerichtshof (Austrian Constitutional Court)
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Part I
Methods and Introduction

The European Union has struggled with the meaning of fiscal federalism in Europe since the Treaty of Maastricht and the creation of the European Monetary Union. The model of fiscal federalism inscribed in the Treaty at Maastricht conceived of national governments as distinct, miniature sovereign borrowers which retained the necessary fiscal tools to manage sovereign economies. EU responses to the financial crisis have overthrown this model.¹ The European bailouts, the (now permanent) European Stability Mechanism (ESM) and a new Article 136(3) TFEU have effectuated a joint liability group.² Fiscal federalism in the EU is now the subject of piecemeal renegotiation that increasingly exceeds the limits of the Maastricht model: A common fiscal backstop, binding Euro Area budget contracts, a concomitant power to rewrite national budgets, direct tax harmonisation, and a jointly-backed Euro Area treasury were all the objects of recent European Council summits or Commission proposals.³ A new, post-crisis federal fiscal model is emerging, yet there is no consensus on what elements of fiscal union are necessary to achieve equilibrium in the new model, and no consensus on what is permissible within the constitutional boundaries of the European legal order.⁴ Where individual measures have inched beyond the boundaries of fiscal sovereignty contemplated by national legal orders, the result has been stirrings of legal revolt and revolution: Legal challenges,⁵ political upheaval,⁶ and divergent national appetites to deepen or repatriate


⁴ See, e.g., Phoebe Athanassiadis, ‘Of past measures and future plans for Europe’s exit from the sovereign debt crisis: what is legally possible (and what is not)’ (2011) 36 EL Rev 558, 559, noting, ‘The legal feasibility of these proposals has been one of their most polemical aspects... not always with a clear idea as to their compatibility with EU law.’ See also: Christian Joerges, ‘The European Economic Constitution and its transformation through the financial crisis’ in Dennis Patterson, Anna Söderstn (eds), A Companion to European Union Law and International Law (Wiley-Blackwell 2013): ‘insights into the construction failures have not led to a consensus about its cure... legal problems with all this abound.’

⁵ See, e.g., Case C-370/12 Pringle v Ireland [2012] OJ C 303; Gauweiler I (Germany) (Case 2 BvR 2728/13) Order of 14 January 2015 (English version); Case C-62/14 Gauweiler v Bundesbank (Gauweiler II) (16 June 2015); Case C-64/14 P Von Storch v ECB II (Fourth Chamber, 29 April 2015); Joined Cases C-8-10/15 Ledra and Others v Commission and ECB (Grand Chamber, 20 September 2016); Joined Cases C-105-109/15 P Mallis and Malli v Commission and ECB (Grand Chamber, 20 September 2016); Case C-41/15 Dowling v Minister for Finance [2015] OJ C 138/31.

European powers. A constitutionally stable European Union therefore depends on how European fiscal federalism is to be defined and delimited in the post-crisis era.

The first principal task of this research undertaking is to identify the constitutional boundaries of fiscal federalism that are integral to the stability of the European Union as a whole. Rules that limit the integration of EU law are a necessity that derives from the nature of European constitutionalism. The European legal order is different to those of other advanced federations that presuppose the existence of a single ‘constitutional demos.’ European constitutionalism is characterised by opposing forces of perennial disquiet, possessed of a top-down federal hierarchy with a greater legal supremacy than any individual expression of Member State sovereignty on one hand, yet on the other hand derived from the confederate authority of national orders which sanction its reach. Previous research has indicated the necessity of a rule that limits the integration of EU law to the degree required to prevent a revolution in national law. Where EU law over-reaches this boundary and demands a court dis-apply a constitutional commitment, the result must either be a repudiation by the national court (which may result in the withdrawal of a Member State), or a revolution wherein either legal order must reconstitute itself to accommodate the other. Blind

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9 A constitutional boundary will be defined in this thesis as an integral constitutional value or structure which cannot be conferred or amended by the national (or European) legislator; which prevents certain legal machineries of public economics from taking effect in the legal system; and so constitutes a permanent constraint on European fiscal federalism.


13 See, e.g. Germany: Re Lisbon (Case 2 BvE 2/08): BVerfGE 123, 267; [2010] 3 CMLR 13 (Bundesverfassungsgericht) [217]-[240] ‘The ultra vires review as well as the identity review may result in Community law or, in future, Union law being declared inapplicable in Germany.’ Italy: Talamucci v Minister of Health (Italy) Case No 1512/98 (13 February 1998) in Oppenheimer, The Cases (Vol II) 388 (Corte di Cassazione), 393 if the EU evolves ‘that the Treaty itself is in conflict with the Constitution,’ this will justify ‘the radical and disruptive remedy of the withdrawal from the European Union.’ Spain: Constitutional Treaty (Spain) DTC 1/2004 of 13 December 2004 (Tribunal Constitucional) [3] referring to ‘sovereignty recoverable by means of the “voluntary withdrawal”.’ Poland: Constitutionality of the Accession Treaty (Poland) (Judgment of 11 May 2005 - K 18/04) in Biblioteka Trybunału Konstytucyjnego, Selected Rulings (Vol L1) (Trybunals Konstytucyjny) [13] (a violation of national constitutional identity could require a withdrawal from the Union).

advancement of novel inventions in the field of public economics without identifying the constitutional limits which must underpin them risks more than individual initiatives: It destabilises the European legal order as a whole.

Many aspects of fiscal union have already stumbled on the limits of the European legal order. The European Financial Stabilisation Mechanism (EFSM), for example, was tacitly acknowledged by the European Council and the ECJ as wanting a proper legal basis before being folded into the ESM and anchored in a new Article 136(3) TFEU. The latter instrument has been the subject of legal challenges in several countries, and is broadly criticised in the economic and legal literature as exceeding the bounds of the Treaty. Following a string of 2011 rulings by the constitutional courts of Germany, Ireland, Austria, Poland, Estonia, and the Finnish Constitution Committee, certain ‘capital call’ provisions of the ESM Treaty (TESM) remain subject to a quantitative cap that clearly contradicts the limitless joint and several liability sanctioned by the ECJ in Pringle v Ireland. Actualisation of that difference could provoke a German-led legal revolt that would cast the ESM into constitutional space and trigger a collapse of the Euro.

ECB asset-purchase programmes, financial memorandums-of-understanding with EU institutions, and Council Decisions setting economic policies provide numerous other instances of fomenting constitutional turmoil. The German Constitutional Court has explicitly stated since its Maastricht decision that it will stage a legal revolt if the constitutional principles of the ‘stabilitätsgemeinschaft’

(2005) 11 ELJ 262, 270 (‘either EU law is changed, national constitutional law is amended, or [a discrepancy] is tolerated).


18 European Economic Advisory Group, The EEAG Report on the European Economy (CESifo, 2011), 33: ‘In this case, the ESM and the euro area would probably be on the verge of collapse.’

19 C-62/14 Gauweiler v Deutscher Bundestag (Grand Chamber, 16 June 2015); Gauweiler III (Germany). See: Brady Gordon, Kathy Bergin ‘Legal or not? Can we afford to doubt?’ (Interdisciplinary Legal Studies, Toronto, 10 June 2017).

20 Joined Cases C-8-10/15 Ledra v Commission and ECB; Joined Cases C-105/10/15 P Mallis v Commission and ECB.

21 See Section 8.5. Case C-41/15 Dowling and others v Minister for Finance [91], [55]-[57]; Case C-64/16 Associação Sindical dos Juízes Portugueses v Tribunal de Contas [2016] OJ C 156/32.
(stability community) are not observed, and in the recent Gauweiler v Bundesbank litigation, it appeared prepared to do so. The European Union must not only redefine its model of fiscal federalism, but ensure that it is anchored within existing constitutional boundaries.

The second principal task of this research is to define which institutional configurations of fiscal federalism remain theoretically and empirically compatible with the European legal order. As a matter of fiscal federalism theory, the legal character of a given federal model depends on its placement on a continuum between (centralised) fiscal union and (decentralised) fiscal federalism. Central to the Treaty model since Maastricht has been a prohibition on financial assistance (Article 125 TFEU, ex Article 103 EC) that enshrines a constitutional consensus on fiscal sovereignty and exposes individual Member States to market discipline. This follows a formula for federal equilibrium that is well-established in theory and well-evidenced in history, visible in the autonomous credit ratings of Swiss Cantons, Canadian Provinces and American States. That model has been vitiates by the (now-realised) bailout expectation. In its wake, numerous aspects of fiscal union are being advanced with no consensus on what model of fiscal federalism is now being pursued, and no consensus on what aspects must be in place for its attainment. Confused fiscal sovereignty carries troubling legal and macroeconomic consequences. In Pringle v Ireland, the ECJ sanctioned an amendment to the TFEU which permits the abrogation of the ‘no bailout’ rule, instead entrusting the task of fiscal discipline to centralised legal governance under Articles 121 and 126 TFEU. Yet the debt limits provided by those provisions are demonstrably lacking in credibility, having already been exceeded 97 times by 24 of the EU-27 countries by the time of the

22 Brunner v EU Treaty (Germany) (Cases 2 BvR 2134/92 & 2159/92): BVerfGE 89, 155: [1994] 1 CMLR 57 [90]; Gauweiler I (Germany) [41]; Aid Measures for Greece (Germany) (Joined Cases 2 BvR 987/10, 1485/10 & 1099/10): BVerfGE 129,124 (English version) [129], [137].
23 In Gauweiler and Others (Gauweiler III) (Cases 2 BvR 2728-2791/13) 21 June 2016 (Bundesverfassungsgericht) the BVerfGE concluded the Gauweiler v Bundesbank litigation by ruling, for the second time, that the ECB’s Outright Monetary Transactions (OMT) programme impinged upon essential constitutional guarantees of fiscal sovereignty, devising the remarkable remedy of placing the Bundesbank and Bundestag in a position of responsibility for monitoring compliance with six conditions set out by the court. See: Sections 6.2-6.3.
25 Art 125 TFEU. See: Pringle v Ireland [135]; Gauweiler II [100]; Gauweiler II (Opinion of AG Cruz-Villalón) [85].
28 See generally, Chapter 3 (on pre-crisis EMU) and Chapter 7 (post crisis-EMU). See further: Rodden (2006), 10.
29 Pringle v Ireland [143]-[147]. See: Chapter 6, in particular Section 6.5.
Pringle decision.\textsuperscript{30} History admonishes that constitutional debt brakes never work in a decentralised federation, and contemporary economists already find the new governance framework less credible than its predecessor.\textsuperscript{31} The sterilisation of Article 125 TFEU invites the federal ailments of transfer dependency and ‘soft budget constraints’ which have plagued the German Federal Republic since it committed that error in the 1980’s – a result explicitly interdicted at Maastricht.\textsuperscript{32}

In simple, in order to remain stable and permanent as a matter of law and economics, European fiscal federalism must do two things: It must (i) be compatible with the constitutional boundaries of the European legal order, and (ii) it must ‘work’ – i.e., it must not be economically unstable.

The thesis of this study is as follows:

First, any model of European fiscal federalism must preserve the fiscal sovereignty of the twenty-eight constitutional democracies which form the basis of its legal order. This means, specifically, that any machineries of public economics which trespass on the tests for democratic legitimation under Member State ‘constitutional identity’ and ‘ultra vires’ review jurisdictions will not take effect in the legal system, and will not be compatible with the European legal order.\textsuperscript{33} A review of constitutional jurisprudence in 27 Member States reveals that all, including the most basic among these jurisdictions, preclude a disposition of the Kompetenz-kompetenz – the competence to decide on competences.\textsuperscript{34} The EU cannot therefore extend its own competences, or depend on legal machineries placed beyond them. The most developed among them, such as Germany’s ‘eternity clause’ entrench a specific formula for democracy: they require, in essence, that x fiscal competences can only be exercised by y institutions according to z formula, and these components themselves are unamendable. Fiscal


\textsuperscript{31} Chapter 7. See e.g. Foremny (2014) (‘fiscal rules… are ineffective in federations’) and Groetke and Mause (2012), 280.


\textsuperscript{33} See, for statements to that effect: Germany: Re Lisbon (Germany) [221] (transfers of German constitutional authority are subject to Arts. 20 and 79 BL). Denmark: Carlsen (Denmark) [13] (‘the authorities of the realm have themselves no such power’). Poland: ESM & TSCG (Poland) [6.3.1] (Art 90 of the Polish Constitution cannot ‘constitute a basis of conferring … competence to enact legal acts or take decisions that would be inconsistent with the Constitution’). Crotty (Ireland), 600-601, 611-612, 619-620, 783, (‘If it is now desired to qualify, curtail or inhibit the existing sovereign power… it is not within the power of the Government itself to do so’). Spain: Maastricht (Spain) [4] (‘the possibility of amending the Constitution is not a “power” whose exercise can be granted.’) UK: Thoburn v Sunderland CC (UK) [69], per Laws LJ (‘there are no circumstances in which the jurisprudence of the [ECJ] can elevate [Union] law a status within the corpus of English domestic law to which it could not aspire by any route of English law itself’). Belgium: European Schools (Belgium) [B.4]. Czech Republic: Lisbon I (Czech Republic) [145], ‘if the Union could change its competences at will… then by ratifying the TL the Czech Republic would violate Art 1 [and] Art. 10a of the Constitution.’

\textsuperscript{34} This thesis covers the EU-27 up to 21 August 2016. Croatia is excluded from this study due to insufficient data and its late accession to the Union.
sovereignty is a permanent constitutional constraint upon the application of fiscal federalism theory in the European Union.

Second, hard budget constraints and individual exposure to market discipline are indispensable requirements for compliance with the fundamental guiding principles of price stability, sound public finances, and a sustainable balance of payments binding on the mandate for EMU itself under Article 119 TFEU. Systems of fiscal federalism theory which substitute hard budget constraints for centralised legal governance are not compatible with the guiding principles of price stability and fiscal discipline, and are not compatible with the European legal order. In particular, the BVerfGE has held that the ‘no bailout’ rule and ‘no monetary financing’ rules safeguard the Bundestag’s ‘national budgetary responsibility,’ and Germany’s constitutional identity would be violated if the Stabilitätsgemeinschaft (Stability Community) should become a ‘liability community’ through the ‘direct or indirect communitarisation of state debts.’

This thesis is extracted from a systematic research agenda divided into two parts according to the two aims of this study. Part I pursues the first principal task of this thesis - to identify the constitutional boundaries of fiscal federalism that are integral to the stability of the European Union as a whole. This half of the thesis deploys a grounded theory methodology, by which the analysis pursues a hypothesis implicit in the data. This methodology is appropriate because, while this thesis begins with the hypothesis that there are, indeed, constitutional boundaries that condition European fiscal federalism lex lata and lex ferenda, it does not begin with a supposition of what those constitutional boundaries might be. A grounded-theory methodology is necessary to extract them before they can be subjected to classical positivist methodologies in the second half of this thesis. Part I proceeds as follows:

[1] Chapter 1 conducts a doctrinal grounded-theory analysis of the ultra vires and ‘constitutional identity’ jurisdictions of the ECJ and twenty-seven Member State constitutional courts in order to

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35 So, for example, as a matter of monetary economics and fiscal federalism theory, a failure to achieve budgetary discipline means inflation, debt mutualisation or centralised legal governance, and this offends the right to property (Article 14 BL) and the right to vote (Article 38 BL) which are part of the Germany constitutional identity in conjunction with Article 1 BL (Human Dignity) and Article 20 BL (the Democratic State) and are not amendable under Article 79(3) BL, lex lata or lex ferenda: Brunner (Germany) [56].

36 Re ESM I (Germany) [203]; Re ESM II (Germany) [167]-[171]; Aid Measures for Greece (Germany) [129], [137]. See also: Gauweiler I (Germany) [41] ‘[A] system of fiscal redistribution... is not entailed in the integration programme of the European Treaties... independence of the national budgets, which opposes the direct or indirect common liability of the Member States for government debts, is constituent for the design of the monetary union.’

37 It should be noted that, unlike positivist methodologies, this procedure does not start with a theory. It depends on inductive reasoning, deriving specific observations from economic, political and legal sources, and extrapolating these observations into testable hypotheses. Each stage of this analysis therefore begins with data collection. From this, key codes are extracted from the text, grouped into concepts and categories, and it is from these that the hypotheses of this thesis are extracted. This thesis adopts the essential framework outlined by Kathy Charmaz, Constructing Grounded Theory (Sage Publications, 2006). On the application of this method in the context of empirical and comparative legal research, see: Lisa Webley, ‘Qualitative Approaches to Empirical Legal Research’ in Peter Cane, Herbert M Kritzer (eds), The Oxford Handbook of Empirical Legal Research (Oxford University Press 2010) 926, in particular at 943-945.

38 This supposition is implicit in a legal order based on ‘the respective constitutional requirements’ of its Member States: Art 48(4) TEU; Art 49 TEU; Art 54 TEU; Art 357 TFEU.
identify the legal principles and judicial tests which will condition the expansion of EU law in the field of public economics.\textsuperscript{39} It evaluates the competing claims of EU and Member-State constitutionalism against three approaches to doctrinal legal theory: Pure (Kelsenian) constitutional theory;\textsuperscript{40} normative (monist) European constitutionalism;\textsuperscript{41} and (Hartian) constitutional pluralism.\textsuperscript{42}

The analysis finds that Member State ‘constitutional identity’ and ultra vires review jurisdictions provide a valid constitutional, normative and positivist description of the limits of the EU legal order, and they exert real positive force on the boundaries of EU law.\textsuperscript{43} Chapter 1 identifies two constitutional boundaries of the EU legal order:

The first is fiscal sovereignty. That principle is implicitly but plainly impressed upon the allocation of competences in economic policy (Articles 2(3) and 5(1) TFEU) and the substantive provisions governing public finance in Articles 121-126 TFEU.\textsuperscript{44} The Union competence for economic policy under these articles is one of ‘mere coordination,’ limited to providing ‘a framework to coordinate these policies to a certain degree.’\textsuperscript{45} The EU has no power to determine the content and composition of government revenues and expenditures,

\textsuperscript{39} This chapter covers the EU-27 up to 21 August 2016. Croatia is excluded from this study due to insufficient data and its late accession to the Union. By ‘constitutional court’ this study refers to the highest court in each Member State with the body to interpret or apply the constitution. In Finland, which has no constitutional court, it refers to the Perustuslakivaliokunnan (Constitution Committee).

\textsuperscript{40} See: Hans Kelsen, Pure Theory of Law (Max Knight tr, 2nd edn, The Lawbook Exchange Ltd 2002), 1-58, 70-101. For the application of pure law in comparative theory: Tushnet (2008), 1230. For the application of this theory in the context of EU law: Arthur Deyvre, 'European Integration and National Courts: Defending Sovereignty under Institutional Constraints?' (2013) 9 EuConst 139, 147. See also, noting that having recourse to Kelsen’s ‘basic norm’ is consistent with the rule of recognition for identifying the norm-creating competences which European ‘monist’ claims also depend on: Neil MacCormick, Legal Reasoning and Legal Theory (OUP 1978); MacCormick, 'Beyond the Sovereign State' (1993); and Bruno De Witte, Sovereignty and European Integration: The Weight of Legal Tradition' in JHH Weiler, Anne-Marie Slaughter, Alec Stone Sweet (eds), European Courts and National Courts: Doctrine and Jursprudence (Hart 1998), 279.

\textsuperscript{41} This is important because the pouvoir constituant and pouvoir constitué may both have constitutions, but not constitutionalism, and it is necessary to determine which legal norm provides a valid description of the boundaries of the legal system (i.e. does black-letter constitutional law bend around EU normative doctrines?). See: Tushnet (2008), 1230.

\textsuperscript{42} An empirical approach to legal positivism seeks to determined which laws will apply, and when. Margaret Davies, 'Legal Pluralism' in Peter Cane, Herbert M Kritzer (eds), The Oxford Handbook of Empirical Legal Research (Oxford University Press 2010) 805: “Legal pluralism” refers to the deceptively simple idea that in any one geographical space defined by the conventional boundaries of a nation state, there is more than one “law” or legal system… sometimes put forward as an empirical state of affairs, a set of facts.’ John Griffiths, ‘What is Legal Pluralism?’ (1986) 24 Int J Legal Plural 1, 4: ‘Legal pluralism is the fact. Legal centralism is a myth, an ideal, a claim, an illusion.’ On comparative constitutional analysis and the methods for separating causality, see: Tushnet (2008), 1230-1234; David S Law, 'Constitutions' in Peter Cane, Herbert M Kritzer (eds), Handbook of Empirical Legal Research (OUP 2010) 376, 388. In the context of the EU, see: Miguel Poiares Maduro, 'Three Claims of Constitutional Pluralism' in Matej Avbelj, Jan Komárek (eds), Constitutional Pluralism in the European Union and Beyond (Hart Publishing 2012) 38; Neil MacCormick, Questioning Sovereignty (OUP 1999).

\textsuperscript{43} On the use of legal theory to predict or explain empirical outcomes, see: DJ Galligan, 'Legal Theory and Empirical Research' in Peter Cane, Herbert M Kritzer (eds), Handbook of Empirical Legal Research (OUP 2010), 981-982, 984-993.

\textsuperscript{44} This thesis follows European policy documents in using both ‘economic policy’ and ‘fiscal policy’ interchangeably to describe any policies which refer to the use of government revenue, debt or expenditure to influence the economy.

\textsuperscript{45} Federico Fabbrini, 'The Fiscal Compact, the “Golden Rule” and the Paradox of European Federalism' (2013) 36 BC Intl & Comp L Rev 1, 35 (‘mere coordination’); Hinarejos, 'Limits to Fiscal Integration' (2014), 244 (‘framework to coordinate”).
dictate structural reforms, or determine social allocations at national level. This is not a mere reflection of good administration under the principle of subsidiarity. Under Articles 4(1), 5(1) and 5(2) TEU, the limits of Union competence are governed by the principle of conferral, and under Articles 48(4) TEU, 49 TEU, 54 TEU, and 357 TFEU, the EU acquires its competences when the Treaties are ‘ratified by the High Contracting parties in accordance with their respective constitutional requirements.’ In so far as this is so, the Union can have no powers other than what the Member States have given it, and nemo plus iuris transfere (ad alium) potest quam ipse habet, what the Member States have given it is limited by their own ‘constitutional identities’ – inviolable principles so integral to the constitutive basis of the state that they can never be impinged or disposed-of without abrogating the national constitutional order. This marks an immutable boundary of the European legal order. Not only has economic policy not been conferred on the Union, but, according to the ‘constitutional identity’ jurisprudence of the BVerfGE, it cannot ever be so conferred without infringing the ‘eternity clause’ (Article 79(3)) of the German Basic Law. Numerous other constitutional courts have drawn similar boundaries around democratic fiscal sovereignty. According to

46 Pringle v Ireland [64]: ‘arts 2(2) and 5(1) TFEU restrict the role of the Union in the area of economic policy to the adoption of coordinating measures.’ Gauweiler I (Germany) [39]: ‘In this field of economic policy, the European Union is... essentially limited to a coordination of Member States economic policies.’ De Nederlandsche Bank, Annual Report 2003 (2004) <http://www.dnb.nl/en/binaries/146939.pdf> accessed 31 March 2015, 27: ‘the transfer of sovereignty relates solely to the balance of revenues and expenditures, and not to their level of composition.’

47 As subsidiarity only applies within the European legal order, subsidiarity ‘did not bite’ on the initial choice of what economic powers should be conferred on the Union: Paul Craig, 'The Financial Crisis, the European Union Institutional Order and Constitutional Responsibility' (2015) 22 Ind J Global Legal Stud 243.

48 Art 4(1) TEU: ‘competences not conferred upon the Union in the Treaties remain with the Member States.’

49 Art 5(1) states: ‘The limits of Union competences are governed by the principle of conferral.’

50 Art 5(2) states: ‘Under the principle of conferral, the Union shall act only within the limits of the competences conferred upon it by the Member States in the Treaties to attain the objectives set out therein. Competences conferred upon the Union in the Treaties remain with the Member States.’

51 Art 48(4) TEU (Ordinary revision procedure); Art 49 TEU (accession procedure); Art 54 TEU (ratification of the TEU); Art 357 TFEU (ratification of the TFEU). See also: Art 42(2) TEU (decision common defence); Art 50(1) TEU (unilateral withdrawal); Art 25 TFEU (amendment of rights); Art 223(1) TFEU (amendment of parliamentary election period); Art 262 TFEU (jurisdiction in IP rights); Art 311 TFEU (amendment of own resources).

52 No one can transfer more rights (to another) than he himself has.’ Aaron X Fellmeth, Maurice Horwitz (eds), A Guide to Latin in International Law (Oxford University Press 2009).

53 See, for statements to that effect: Germany: Re Lisbon (Germany) [221] (transfers of German constitutional bodies subject to Arts. 20 and 79 German BL). Denmark: Carlsen v Rasmussen (Case I 361/1997); [1999] 3 CMLR 854 (Højesteret (Supreme Court of Denmark)) [13] (‘the authorities of the realm have themselves no such power.’) Poland: ESM & TSCG (Poland) [6.3.1]. Ireland: Society for the Protection of Unborn Children Ltd. (SPUC) v Grogan [1989] 1 IR 753 (Supreme Court), 769 and 770 per Walsh J. Belgium: European Schools (Belgium) [B.4]: ‘the Constituent Assembly, which has forbidden the legislature to pass rules contrary to those referred to by the Constitution, may not be supposed to have authorised the same... through assent to an international Treaty.’ Czech Republic: Lisbon I (Czech Republic) [145].

54 This thesis covers the EU-27 up to 21 August 2016. Croatia is excluded from this study due to insufficient data and its late accession to the Union.

55 Brunner (Germany) [91]; Re Lisbon (Germany) [228], [232]; Aid Measures for Greece (Germany) [107], [127]; Re ESM I (Germany) [193], [196]; Re ESM II (Germany) [161]-[165]; Gauweiler I (Germany) [28]; Gauweiler III (Germany).

56 France: Re Ratification of the European Treaty (Re Maastricht I) (France) Decision no 1992-308 DC (9 April 1992) [1993] 3 CMLR 345 (Conseil Constitutionnel) [43]; Re Treaty on European Union (Re Maastricht II) (France) Decision No 93-312 DC (2 September 1992) in Oppenheimer, The Cases (Vol 1) 399 (Conseil Constitutionnel) [31]-[35], [42]-[43]; TSCG (France) Decision No 2012-653 DC (9 August 2012) (Conseil Constitutionnel) [16]. Ireland: Crotty v An
these jurisdictions, a trespass on budgetary sovereignty would require the Member States to repudiate the advance (refusing to apply the EU law) or withdraw from the Union altogether.

The second constitutional boundary identified in this thesis is comprised of the fundamental guiding principles of price stability, sound public finances and a sustainable balance of payments set forth in the mandate for EMU under Article 119 TFEU. It is the achievement of these principles which inform the entire architecture of Title VIII (Economic and Monetary Policy) of the TFEU, and it is by these principles which that architecture is defined and delimited. This, too, reflects a (national) constitutional boundary of the European legal order: According to the BVerfGE, the fundamental principles of the Stabilitätsgemeinschaft (Stability Community) are ‘the basis and subject-matter of the German Act of Accession.’ This encompasses, specifically, the price stability mandate of the ECB (Article 127 TFEU), the prohibition on monetary financing (Article 123 TFEU), the ‘no-bailout’ clause (Article 125 TFEU), and the stability criteria of the ‘Stability and Growth Pact’ (Articles 121,126 TFEU). A development contrary to that constitutional authorisation would violate the conditions subject to which monetary policy was conferred, mandating Germany, at minimum, to withdraw from the monetary union.

[2] Chapter 2 identifies where the constitutional boundaries pursued in this thesis inhere in the architecture of Chapter 1, ‘Economic Policy’ of Title VIII TFEU, and explains the basic principles of

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56 See, e.g., Brunner (Germany) [33], [52], [99]: ‘Such an interpretation of enabling rules would not produce any binding effects for Germany.’ See also: Re Lisbon (Germany) [314].

57 See, e.g. Germany; Re Lisbon (Germany) [240]. Poland: Accession Treaty (Poland) [13]; Brussels Regulation (Poland), ground 2.7. Spain: Constitutional Treaty (Spain) [3] (referring to the ‘voluntary withdrawal’). Italy: Talamucci (Italy), 393 (referring to ‘the radical and disruptive remedy of the withdrawal from the European Union’).

58 Art 119(3) reads: ‘These activities of the Member States and the Union [economic and monetary union] shall entail compliance with the following guiding principles: stable prices, sound public finances and monetary conditions and a sustainable balance of payments.’

59 Pringle v Ireland [48], [51], [55], [77], [92], [135]. See also: European Council, ‘Conclusions of the Presidency of European Council in Madrid, 15-16 December 1995’ (1995) Bull EC 12-1995, 24: ‘the entire design of the monetary and economic rules in the treaty is ‘guided by the overriding Treaty objective to create a stable single currency.’

60 Brunner (Germany) [80]-[89]; Aid Measures for Greece [129]; ESM I (Germany) [203]; Gauweiler I (Germany) [32].

61 Brunner (Germany) [89], [204]-[205]; Aid Measures for Greece (Germany) [181]-[182]. ESM I (Germany) [203]-[204].

62 Brunner (Germany) [89], referring to ‘withdrawal from the Community in the event of the Stabilitätsgemeinschaft failing to materialise.’

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fiscal federalism theory inscribed in the Treaty for their achievement.\textsuperscript{63} Fiscal sovereignty and price stability are found to penetrate, in identical form, three levels of investigation: The travaux préparatoires and the mandate for EMU (Article 119 TFEU); the allocation of competences in economic policy (Articles 2(3) and 5(1) TFEU); and the technical architecture governing public finance itself (Articles 121-126 TFEU, ex Articles 98-104 EC). By these provisions, European fiscal federalism is shown to rest upon two principles:

Fiscal sovereignty: Member States have complete fiscal autonomy, left to their devices outside the EU legal order and responsible for their own budgetary policies; and

Hard budget constraints and market discipline: In a monetary union bound by fiscal sovereignty, the cost-levying function of markets is relied upon to internalise the costs of poor economic decisions with those who opt for them, so safeguarding the principles of fiscal discipline and price stability.

[3] In order to extract economic criteria for European federalism, Chapter 3 applies an ‘economic analysis of the law’ methodology to public accounts statistics and the corpus of an economic literature beginning with Optimum Currency Area (OCA) Theory and the ‘Walters Critique’,\textsuperscript{64} and continued post-crisis by Fagan and Gaspar,\textsuperscript{65} Giavazzi and Spaventa,\textsuperscript{66} and Philip Lane (among others).\textsuperscript{67} It traces the economic antecedents of the 2008 financial crisis along a chain of macroeconomic indicators that describe a pattern of causality running from nominal interest-rate convergence to the sovereign debt crisis. It concludes that the fundamental failure of European fiscal federalism is a severe mispricing of private and public debt caused by a failure of Articles 121-126 TFEU to induce markets to differentiate between sovereign borrowers under a (now realised) bailout expectation. Nominal interest-rate convergence – not sovereign debt – is the causa sine qua non of the European sovereign debt crisis.

[4] Chapter 4 summarises the conclusions of Part I and provides directions for the positivist empirical methodologies employed in Part II.

\textsuperscript{63} On the procedures for applying grounded-theory methods to historical research, see: Robert B Burns, Introduction to Research Methods (SAGE Publications 2000) 481-491.


\textsuperscript{66} Francesco Giavazzi, Eleanor Spaventa, ‘The current account in a monetary union’ in Miroslav Beblavy, David Cobham, L’udovit Ődor (eds), The Euro Area and the Financial Crisis (Cambridge University Press 2011), 199.

\textsuperscript{67} An economic analysis of the law methodology refers to a system for using economic theory to explain or predict certain facts. See: Florian Faust, ‘Comparative Law and Economic Analysis of Law’ in Reimann and Zimmerman (eds), The Oxford Handbook of Comparative Law (Oxford University Press 2008) 837, 839-847: ‘Positive economic analysis may be employed retrospectively that is, in order to explain why the law-be it statute or case law-developed in a specific way.’ In the context of financial markets, see: Julia Black, ‘Financial Markets’ in Cane and Kritzer (eds), The Oxford Handbook of Empirical Legal Research (Oxford University Press 2010) 151, in particular on market development: 159-162.
Part II (Chapters 5-8) pursues the second undertaking of this study: to identify which configurations of fiscal federalism theory remain empirically and theoretically compatible with the constitutional constraints extracted in Chapters 1-4. Chapters 5-8 conform to a classical positivist methodology using established legal precedent and empirical economic data for inputs.\(^6\) This is necessary because, while price stability is narrowly defined within EU competence under Article 127 TFEU, the antecedent precepts of fiscal discipline depend on the balance of incentives which play on elected governments in a federated monetary union.\(^6\) The mandate for price stability, a creature of monetary economics, is therefore predicated on the field of public economics known as fiscal federalism.\(^7\) The procedures and methodologies applied in Part II are as follows:

[5] Chapter 5 finds that the emergent European fiscal framework supplants a legal pillar of fiscal sovereignty (an entrenched ‘no-bailout’ law) with a legal feature of unitary states: Financial assistance and centralised governance of fiscal policy.\(^7\) This hearkens to an extremely centralised model of fiscal union that appears unfaithful to the original constitutional bargain. If it weren’t, the EU would not have needed to amend Article 136 of the Treaty that governs the union. This yields three operational hypotheses, tested for the duration of Part II:

[6] That financial assistance and centralised legal governance, being such a departure from the Treaty model, must not conform to the legal architecture in Chapter 1 ‘Economic Policy’ of Title VIII of the TFEU for the guiding principles of price stability and fiscal discipline as a matter of law;

[7] That financial assistance and centralised legal governance, being such a departure from the legal criteria for hard budget constraints and market discipline, must not comply with the guiding principles of price stability and fiscal discipline as a matter of economic fact; and

[8] Financial assistance and centralised legal governance does not conform to the boundaries between EU law and Member State fiscal sovereignty.

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\(^6\) See Wing Hong Chui, *Quantitative Legal Research* in Mike McConville, Wing Hong Chui, *Research Methods for Law* (Edinburgh University Press, 2007), 46.

\(^6\) Pipkorn (1994) 272: it is ‘up to the Member States to conduct an economic policy that complies with the principles at the basis of the Economic and Monetary Union.’ See also: Matthias J Herdegen, 'Price Stability and Budgetary Restraints in the Economic and Monetary Union: The Law as Guardian as Economic Wisdom' (1998) 35 CMLR 9, 23.

\(^7\) Marek Dabrowski, ‘Monetary Union and Fiscal and Macroeconomic Governance’ (2015) European Economy Discussion Papers No 13, 27: ‘Thus, the question of how much fiscal and political integration is needed must be answered… by the theory of fiscal federalism.’ Similarly: Charles Wyplosz, 'The Centralization-Decentralization Issue' (2015) European Economy Discussion Papers No 14, ‘The Make-up of the EU institutions, and their evolution, should explicitly be based on accepted federalism principles.’

[6] The ‘Pringle Hypothesis’ upon which the blueprint for European ‘fiscal union’ is based, is that financial assistance and centralised legal governance is both contemplated by the existing Treaties and capable of replacing ‘the logic of the markets’ in preserving the incentive for fiscal discipline.\textsuperscript{72} Were it not so, the conditions set out by the court in \textit{Pringle v Ireland} would not be met, and financial assistance would be unlawful. In simple, bailouts are reconcilable with the Treaty \textit{in so far as} centralised legal governance is competent, both \textit{de facto} and \textit{de jure}, to replace hard budget constraints in fulfilling the precepts of fiscal discipline binding on the mandate for EMU.\textsuperscript{73} Chapter 6 examines that question as a matter \textit{de jure}.\textsuperscript{74} It concludes, unavoidably, that financial assistance and conditionality simply does not fall within the range of instruments reconcilable with the framework of the Treaties. This emerges from an analysis of the allocation of competences (within which the ESM does not sit) and the substantive provisions of Articles 121-126 TFEU (to which the ESM does not adhere). By restoring an interpretation of the Treaty which was rejected under Articles 104-104a of the Commission’s 1990 draft Treaty at Maastricht, the ECJ would seem to have reached back through history, brushed aside the stated will of the Treaty drafters, plucked the (rejected) Commission draft Treaty from the floor of Maastricht, and enacted it into primary law.

[7] Chapter 7 tests the ‘Pringle Hypothesis,’ \textit{a posteriori}, as a matter of economic fact. It applies a positive ‘economic analysis of the law’ methodology to the literature on public finance in order to extract the legal determinants of fiscal discipline in a monetary union.\textsuperscript{75} It then examines the EU’s performance against those determinants in comparative analysis of five federations using a ‘most similar cases’ and a ‘prototypical cases’ methodology: The EMU, Federal Republic of Germany, the Swiss Confederation, the United States of America, and Canada.\textsuperscript{76} It finds that the ‘Pringle

\textsuperscript{72} \textit{Pringle v Ireland} [135]: The purpose of Article 125 and the companying framework is to ensure that Member States ‘remain subject to the logic of the market when they enter into debt, since that ought to prompt them to maintain budgetary discipline, which is in turn contributes to a yet higher objective, the financial stability of the monetary union.’ See also: \textit{Gauweiler II (ECJ)} [100].

\textsuperscript{73} \textit{Pringle v Ireland} [135]: The Treaty ‘prohibits the Union and the Member States from granting financial assistance as a result of which the incentive of the recipient Member State to conduct a sound budgetary policy is diminished.’ Cf: \textit{Gauweiler III (Germany)} [3](c) ‘Against this backdrop, one must assume that the Court of Justice considers the conditions it specified to be legally binding.’

\textsuperscript{74} Following \textit{Pringle}, the analysis conducts a doctrinal analysis using ordinary canons of statutory interpretation, a systemic analysis of the Treaty, and a teleological analysis.

\textsuperscript{75} On the application of this method to comparative analyses, see: Faust (2008), 839- 847.

Hypothesis’ is - quite simply and profoundly - wrong. While history bears many successful examples of pure market discipline, or (fiscal rules + market discipline), there are no successful examples of fiscal rules without market discipline. The new model institutionalises the dysfunctional economic incentives identified in Chapter 3, and national accounts data already show that the new model is not compatible with sound public finances and a sustainable balance of payments. Allowing Member States a margin of error of 0.5% of GDP, this study counts 102 nominal breaches of the 3% of GDP deficit limit by 23 countries between 2009-2015, and 16 countries in breach of the 60% debt limit – only two of which (Hungary and Malta) have decreased their debt since 2009 (the rest have increased it). Yet rule-breakers are far more likely to receive a bailout (which count stands at €500.07bn dispersed over eight separate bailout agreements for five Member States), than they are to face sanctions under EU law (which count stands at €0.00 fines levied). Such a result is clearly at odds with the fundamental guiding principles of fiscal discipline binding on the mandate for EMU under Article 119(3) TFEU.

[8] Chapter 8 pursues the final, and perhaps most important, operative hypothesis of this thesis: If the investigations in Chapters 6 and 7 are correct, then the new model does not conform to the allocation of competences in the Treaty; does not conform to the boundary between EU law and Member State constitutional democracy; and is dependent on the good functioning of legal machineries which are beyond the EU legal order. In pursuance of that hypothesis, Chapter 8 conducts a piece-by-piece deconstruction of the European governance framework to identify instruments which explicitly, or a fortiori implicitly, trespass on ultra vires and constitutional identity rulings of national constitutional courts. It finds that fully seven out of eight legal machineries upon which the new ‘fiscal union’ depends are vulnerable to ultra vires review or constitutional identity review by at least one EU or

77 ‘Evidence shows that fiscal responsibility laws … are not a substitute for commitment and should not be viewed as ends in themselves.’ Lili Liu and Stephen B Webb, ‘Laws for Fiscal Responsibility for Subnational Discipline’ (2011) World Bank Policy Research Working Papers No 5587, noting, ‘They can make a positive contribution by adding to the collection of other measures to shore up a coalition of states [but] One common trait of successful fiscal responsibility laws for subnational governments is the commitment of the central government to its own fiscal prudence.’

78 See: Sections. 3.1.2 and 3.1.5.


80 Belgium, Denmark, Ireland, Greece, Spain, France, Croatia, Italy, Cyprus, Hungary, Malta, the Netherlands, Austria, Portugal, Slovenia and the UK are all in breach of the 60% limit as of January 2017: Eurostat, ‘Government consolidated gross debt (gov_10dd_3dpt1)’ (25 April 2016) <http://epp.eurostat.ec.europa.eu> accessed 14 September 2016.

81 This €500.07bn figure encompasses all EU bailouts from May 2010 and December 31 2016 and excludes an additional €43.35bn out of an agreed €60.75 in BoP assistance to Romania, Latvia and Hungary. Greece I: €20.1bn (IMF) + €52.9bn (BGLF). Greece II: €172.6bn (€28bn from IMF + €144.6bn from EFSF) (this included the remaining amount from Greece I, which was €110bn). Greece III: €86bn (ESM+IMF) from August 2015 to August 2018. Ireland: €68.2bn (€4.8bn bilateral + €22.5bn EFSM + €18.4bn EFSF). Portugal: €79bn (€26.3bn IMF + €24.3bn EFSM + €26bn EFSF). Spain: €43bn out of €100 ESM. Cyprus I: €2.5bn bilateral using ESM as disbursement. Cyprus II: €10b (€1bn IMF + €9bn ESM).

82 A legal instrument will be explicitly outside the boundaries of the European Union where it has been the subject of an ultra vires ruling by either the EU or the Member States. The OMT program is an example of an instrument for which this has occurred. An instrument will be implicitly outside the boundaries of the European Union where it violates a previously-set or acknowledged boundary of EU law by either the CJEU or a national court. The EFSM, the ESM (owing to conflicting rulings on capital calls), and the OMT (owing to the ruling in Gauweiler III) are instruments for which this has occurred.
Member State constitutional court. Chapter 8 proffers a roster of specific amendments that must be made to defuse latent conflicts under existing legislation.

This study concludes that the European Union has sunk the foundation-stones of a model of fiscal union that is fundamentally incompatible with the European legal order. In order to stem the dysfunctional cost incentives entailed with the abrogation of Maastricht and make the new model ‘work,’ it now depends, for its effective operation at EU level, on continuous Member State acquiescence to intensified governance regimes that bear no relation to the legislative competences of the Union. At Member State level, it is dependent on the constitutionality of a complex and beguiling ‘quasi-legislative’ legal framework which has stretched athwart the gap between legal orders and injected binding interlinkages directly into Member State fiscal frameworks and constitutional law. The result of these interlinkages is a sort of conjunctive direct effect: Substantive, sanction-backed EU economic policies are not directly applicable at national level, but the result is the same: The EU writes the policy prescription, and national courts must enforce it under binding secondary EU law. This is a feature of unitary states that the European constitutional order simply cannot support.  

The analysis concludes by specifying the specific criteria which European fiscal federalism must meet in order to remain stable and permanent as a matter of law and economics, and the conclusion of the study offers two permanent proposals to stabilise European fiscal federalism in the long term.

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83 See e.g. Fabbrini (2013) [34]: ‘Indeed, in the United States, because of the federal system of government, it would arguably be impossible for the federal government to mandate to the states the incorporation of specific budgetary rules in the state constitutions and to require state legislatures and governors to submit draft budgets for prior approval in Washington DC.’ (Emphasis in original).
1. The Constitutional Boundaries of European Fiscal Federalism
1. Introduction to the Constitutional Boundaries of European Fiscal Federalism

This chapter introduces and establishes the constitutional boundaries which are the object of this study:

[1.3.1] The first is fiscal sovereignty: Those exclusive fiscal competencies that comprise the ‘core of parliamentary rights’ and the material substance of ‘constitutional identity’ in Europe’s twenty-eight constitutional democracies, implicitly but plainly impressed upon the allocation of competences in economic policy (Articles 2(3), 5(1), 121-126 TFEU);86 and

[1.3.2] The second is comprised of the fundamental guiding principles of price stability, sound public finances, and a sustainable balance of payments which are set forth in the mandate for the establishment of EMU under Article 119 TFEU. It is these principles which form the basis of Member State (in particular, German) acts of accession, and it is these principles to which the entire architecture of EMU under Articles 119-127(1) TFEU is attuned.87

The essential object of this thesis is to demonstrate that these constitutional boundaries are real, they are permanent, and they are dangerous: A model of fiscal federalism constructed upon these divisions between EU and national legal orders risks being rent asunder by competing claims of constitutional and EU law.88 A law which is beyond the reach of the national (or European) legislator cannot be amended by the institutions of the Union, and an instrument which violates the law cannot take effect in the legal system. When selecting an economic model of fiscal federalism, the question of whether there are permanent constitutional limits on the EU legal order, and where they might lie, is therefore logically prior to the question of whether a specific economic model might ‘work.’89

86 Fundamental decisions on public finance and expenditure are ‘a fundamental part of the ability of a constitutional state to democratically shape itself,’ ‘the core of parliamentary rights in democracy,’ and ‘an essential manifestation of constitutional democracy’: Aid Measures in Greece (Germany) [101], [104]. On the absence of EU competence in economic policy, see: Hinarejos, 'Limits to Fiscal Integration' (2014), 244; Fabbrini (2013), 35; Pringle v Ireland [64]; Gauweiler I (Germany) [39].
87 See, e.g., Brummer (Germany) [86], [89], [90]: Art 119 TFEU sets up the guiding principles for member-Sates’ activities the maintenance of price stability, sound public finances and monetary conditions, and a sustainable balance of payments. This conception of the currency union… is the basis and subject-matter of the German Act of Accession.’
88 For other authors which remark these or similar limits, see: Hinarejos, 'Limits to Fiscal Integration' (2014); Peter M Huber, The Rescue of the Euro and its Constitutionality in Wolf-Georg Ringe, Peter M Huber (eds), Legal Challenges in the Global Financial Crisis: Bail-outs, the Euro and Regulation (Hart Publishing 2014) 9, 11-14; Edoardo Chiti, Gustavo Teixeira (2013), 698; Nicholas Jabko, 'Which Economic Governance for the European Union? Facing up to the Problem of Divided Sovereignty’ (2011) SIEPS Report No 2 8-9; Dawson and de Witte (2013); Ingolf Pernice, 'Domestic Courts, Constitutional Constraints and European democracy: What Solution for the Crisis?’ in Maurice Adams, Federico Fabbrini, Pierre Larouche (eds), The Constitutionalization of European Budgetary Constraints (Hart Publishing 2014) 297. See also: Kaczorowska (2013), 239 ‘The principle of supremacy has limitations arising from the EU law itself: First, the EU can only act within the limits of its competences; second… the EU must respect the national identity of the Member States.’
However, before the constitutional boundaries which bear upon this particular field of public economics can be introduced (in Section 1.3), it must first be established that there are, indeed, constitutional boundaries which apply to the European legal order as a whole. This is so because, as a matter of pure EU law, the boundaries of the EU legal order are limitless in their potential. The scope of EU law is set out by the Treaties, and there are no substantive constraints on the amendment of those Treaties. Outside of the amending procedures, the CJEU has refused to examine the legality of Treaty amendments on the simple basis that those amendments are made by the Member States. From the internal perspective of the EU legal order, any model of federalism is theoretically compatible with European law upon the flourish of 28 pens.

Then, once a competence has been conferred on the Union, the ECJ has, since Costa v ENEL and Internationale Handelsgesellschaft, declared that EU law has absolute primacy over all constitutional laws and structures of the Member States. National law must be interpreted in conformity with EU law, and where they are in conflict, EU law must prevail. The CJEU is the sole arbiter of the legality of all EU measures, and it reserves for itself the final authority to deliver binding rulings on the compatibility of EU law with fundamental rights and principles. Secondary instruments such as regulations, directives, or decisions, will prevail over national constitutional or statute law, even if the national law is later in time.
Constituent within this supremacy claim is what is referred to in this study as the claim of ‘absolute’ supremacy: Not only does European constitutional doctrine determine the status and effect of EU law within its established competences (‘ordinary’ supremacy), but the CJEU is the ‘final arbiter’ of the boundaries between Member State and EU competence (‘absolute’ supremacy).  

The question for the architects of European fiscal federalism is whether this provides a true account of European constitutional law, or whether national legal orders are indeed capable of placing constraints upon new legal machineries erected in the field of fiscal federalism. In pursuit of that question, this chapter proceeds in three sections:

[1.1] The analysis begins by familiarising the reader with European constitutional theory and the competing claims of Member State and EU constitutionalism. What is normatively at stake in this dispute is the locus of sovereignty, and therefore the question of Kompetenz-kompetenz - that is, who is the ultimate arbiter of which competences have and have not been conferred on the Union. It should be noted at the outset, however, that this study is not dependent on the theoretical dispute, and it does not seek to resolve it. This study does not argue where the boundaries of EU law should lie in order to accommodate an ideal model of public economics. Nor does it resolve the question, so intelligently debated elsewhere, of whether Member State courts are correctly interpreting their own constitutions when they enunciate ultra vires jurisdictions. This thesis has an applied aim: To identify an economically-stable model of fiscal federalism which can be safely reconciled with the stated boundaries of the European legal order. In short, this study is concerned with what will happen (or what the law is) if a given machinery from the field of public economics is constructed upon divisions of constitutional and EU law, not necessarily what should happen (or what the law should be). It seeks to identify which rules will be applied to machineries of public economics if it is attempted that they be into operation.


103 It should be noted that this is not intended to ally with Kelsen’s famous theory of ‘pure’ law. This chapter does not aim to ‘free the science of law with alien elements.’ Quite the opposite, if the science of (Member State) pure constitutional law says that a machinery of public economics should not be applied, and the machinery is nonetheless applied, this thesis will accept that operation as an authoritative statement of what the law is. Cf: Kelsen (2002) 1.  

104 On the application of this method to comparative analyses, see: Faust (2008), 839- 847.
[1.2] In the European Union, national constitutional orders profess to impose two types of limitation on the EU’s conferred powers: First, Member State constitutional organs profess that they have the jurisdiction to assert, through Treaty ratification and ultra vires review, what powers they have and have not conferred on the Union - the so-called kompetenz-kompetenz.\(^{105}\) Second, Member State constitutional courts assert that their own constitutional identities determine the absolute limits of Union law – the so-called ‘constitutional identity’ review jurisdiction.\(^{106}\) Section 1.2 finds that these jurisdictions provide a valid constitutional, normative and positive description of the limits of the EU legal order for the purposes of this study. Of the twenty-seven Member States surveyed in this thesis,\(^{107}\) not a single Member State accepts ‘absolute’ constitutional supremacy of EU law over the kompetenz-kompetenz, and nineteen constitutional authorities have developed a body of jurisprudence surrounding constitutional identity – a set of constitutive principles so integral to the constitutional existence of the state that they are beyond the reach of the national (or European) legislator.

Section 1.3 conducts the main task of this Chapter: To identify those constitutional boundaries of the European legal order which bear upon the field of fiscal federalism. It identifies where the boundaries of fiscal sovereignty and price stability inhere in the Treaties and Member State constitutional law, and sets out the tests which constitutional courts (and this thesis) will apply to novel legal inventions in the field of fiscal federalism.

1.1 An Introduction to European Constitutionalism

1.1.1 European Monist Federalism and the Principle of Supremacy

The European Union is founded on the principle of democracy.\(^{108}\) The essential precept of constitutional democracy common to the legal heritage of the Member States is that the bearer of sovereignty is the people.\(^{109}\) Under European ‘social contract’ theories of constitutionalism, the locus

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\(^{105}\) For discussion of Kompetenz-kompetenz, see: Tobias Lock, 'Why the European Union is not a State' (2010) 5 EuConst 407. See also: Re Lisbon (Germany) [209], [215].

\(^{106}\) For other authors which identify these limits, see Hinarejos, 'Limits to Fiscal Integration' (2014); and Huber (2014), 11-14: ‘In the end there are two limits to European integration derived from national constitutional law: (a) the national or constitutional identity on the one hand and (b) the programme of integration on the other (b).’

\(^{107}\) This chapter covers the EU-27 up to 21 August 2016. Croatia is excluded from this study due to insufficient data and its late accession to the EU (on 1 July 2013).

\(^{108}\) Art 10 TEU states: ‘The functioning of the Union shall be founded on representative democracy.’ The founding documents of all twenty-seven of Europe’s constitutional democracies contain a similar principle. See, e.g. Constitution of October 4, 1958 (France) (Amendments to Constitutional Act no. 2008-78 of 23 July 2008, Assemblée Nationale, 2008), art 3 (‘[N]ational sovereignty belongs to the people who shall exercise it through their representatives and by means of a referendum.’); Constitution of Ireland (Department of the Taoiseach, 2015), art 6.1 (‘All powers of government, legislative, executive and judicial, derive, under God, from the people, whose right it is to designate the rulers of the State and, in final appeal, to decide all questions of national policy.’)

\(^{109}\) Under this common heritage, people are not merely subjects of the state but, in a democratic state, the sole source of legitimation for state sovereignty. For an overview of sovereignty in European constitutionalism and classical international law, see: FH Hinsely, Sovereignty (2nd edn, Cambridge University Press 1986) , 41; Edward S Corwin, 'The "Higher Law" Background of American Constitutional Law' (1928) 42 Harv L Rev 149, 151-152; Derek Croxton, 'The Peace of Westphalia of 1648 and the Origins of Sovereignty' (1999) 21 Int Hist Rev 569; Edward McWhinney,
of sovereignty is indivisible.\textsuperscript{110} At the base of every legal order is an historically first constitution - a revolutionary act - which is enacted by the pouvoir constituent originaire in a manner different from that prescribed by any prior constitution.\textsuperscript{111} This is Kelsen’s ‘basic norm’ (or Grundnorm)\textsuperscript{112} which forms the basis for the legal system and authorises the exercise of state power subject to the rule of law.\textsuperscript{113} According to European constitutional theory a ‘Union of States’ must, therefore, either be a ‘confederation’ (under which participants retain their character of sovereign states)\textsuperscript{114} or a sovereign ‘Federal State’ (under which powers are devolved at pleasure by the central government).\textsuperscript{115} In a conflict of norms, only one institution can have the ultimate claim to empowerment by the pouvoir constituent.\textsuperscript{116} Schütze explains:

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\textsuperscript{111} So, for example, the US moved from ‘confederation’ to ‘federation’ when the Constitution was enacted by constitutional convention, and given an amending formula not subject to majority. Alexander Hamilton, James Madison and John Jay, Terence Ball (ed) The Federalist (2003). See also Corwin (1928), 151: the supremacy of the US constitution owed ‘exclusively to the fact that … it was “ordained” by “the people of the United States.”’ Similarly, Canada moved from ‘confederation’ to ‘federation’ when the 1982 Canada Act was adopted with the approval of nine out of ten provinces, instead of unanimity as amendments were historically done: WH McConnell, ‘Cutting the Gordian Knot: The Amending Process in Canada’ (1981) 44 L & CP 195. Similarly, Switzerland moved from five centuries of ‘confederation’ to a ‘federation’ in 1815, when it enacted a new federal constitution by referendum.

\textsuperscript{112} Kelsen (2002). See also: Carl Joachim Friedrich, Constitutional Government and Democracy: Theory and Practice in Europe and America (Ginn 1950); Paul Kirchhof, ‘Der deutsche Staat im Prozess der europäischen Integration’ in Paul Kirchhof Josef Isensee (ed), Handbuch des Staatsrechts, vol VII (CF Müller 1992) 855, 887; Peter Häberle, ‘Die europäische Verfassungsstaatlichkeit’ (1995) 78 Kristische Vierteljahresschrift für Gesetzgebung und Rechtswissenschaft 298, 300 (state authority derives from the pouvoir constituent - there can be no prior state and no greater state authority than granted by the constitution). The Grundnorm is also the starting point of ‘power-confering rules’ under Hart’s ‘Rule of Reason’, by which members of society can identify the primary rules of society (though Hart’s conception can lead to a shifting of the Grundnorm without a revolutionary act). See also: Schilling (1996) (arguing that the EU does not have a grundnorm); Kumm, ‘Final Arbiter’ (1999), 366; Carl Schmitt, The Concept of the Political (George Schwab tr, University of Chicago Press 1996), 35, 41 (examining the ultimate source of authority in conflicts of norms).

\textsuperscript{113} Kelsen (2002); Friedrich (1950); Kirchhof (1992) 855, 887; Häberle (1995), 300. This is arguably even the basis for UK constitutionalism. See: Corwin (1928) 151 (comparing the US constitution to the Magna Carta as the ‘higher law’ of England).


\textsuperscript{115} See, e.g., Georg Jellinek, W Pauly (ed) Die Lehre von den Staatenverbindungen (Kiep 1996) 290-291 as translated in Schütze (2015) 52: ‘Whatever the actual distribution of competences, the Federal State detains its character as a sovereign State; and, as such, it potentially contains within itself all sovereign powers, even those whose autonomous exercise has been delegated to the Member States.’

\textsuperscript{116} Schilling (1996).
‘Within this European tradition, ‘federalism’ came thus to refer to the constitutional devolution of power within a sovereign nation. A federation was a Federal State.’\textsuperscript{117}

For this reason, European constitutionalism from the 1960’s to mid-1980’s treated the residual existence of Member State sovereignty as incompatible with EU federalism. The object of European law, namely, ‘to substitute a common and uniform European law for the divergences and conflicts of national bodies of legislation,’ required early European jurists to free it from the obvious criticism that there could be no such thing as an autonomous legal order superior to the Member States.\textsuperscript{118} The European court needed to assert its own Grundnorm - its own sovereignty - independent from the Member States.\textsuperscript{119} As Schütze so puts it, ‘[i]t became the task of European scholarship to make the “Federal State” look like its unitary sisters … through feats of legal “reasoning.”’\textsuperscript{120}

For this, the court set out on a process of constitutionalisation beginning in the mid-1960’s.\textsuperscript{121} In Van Gend, and Costa v ENEL the Court famously stated that through ‘the establishment of institutions endowed with sovereign rights’ the Community constituted an ‘autonomous legal order’ stemming from ‘an independent source of law.’\textsuperscript{122} This ‘constitutionalisation’ of the Treaty is the ‘grand narrative’ of European constitutionalism.\textsuperscript{123} By asserting that the ratification of the treaties was a constituent act, an historically-first basic norm for a ‘legal constitution of the Community,’\textsuperscript{124} the European courts fashioned a constitutional basis for a federal or a ‘federal-type structure’ in Europe.\textsuperscript{125}

\textsuperscript{117} Schütze (2015), 50.
\textsuperscript{119} As Judge Pescatore (1970), writes the ‘fundamental concern of spokesmen for “European Law” [was] to assert the character of the legal system … as a system which is both autonomous and closed.’
\textsuperscript{120} Schütze (2015), 51.
\textsuperscript{124} Pescatore (1970), 179. See: Eric Stein, 'Lawyers, Judges and the Making of a Transnational Constitution' (1981) 75 Am J Comp L 1, 1; Weiler, 'The Transformation of Europe' (1990-1991), 2407, stating, ‘on this reading, the Treaties have been “constitutionalized” and the Community has become an entity whose closes structural model is no longer an international organization but a denser, yet nonunitary policy, principally the federal state. See also: Schilling (1996), 391, 393; Lenaerts, 'Basic Constitutional Charter' (2010) 295.
\textsuperscript{125} Les Verts, 1365; EFTA [21]; Kadi [81]. Judge Lenaerts, writing extra-judicially, explained: '[A]lthough the EEC Treaty presents itself as a compact among sovereign states, it is in reality, a “constitution” of a central legal order, federally related to the legal orders of the Member States.'Koen Lenaerts, 'Constitutionalism and the Many Faces of Federalism' (1990) 38 Am J Comp L 205, 209, 2010. See also: Pescatore (1970), 172, arguing that, although it is ‘no doubt true’ that the union was founded on international treaties made according to the classic procedure of international law, it remains that they ‘are also the constitution of a system of institutions.’

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From this ‘federal type’ constitution, beginning in 1963, the ECJ asserted the direct applicability and supremacy of EU law over all national legislative and constitutional law.\textsuperscript{126} This made the EU legal order ‘indistinguishable from analogous legal relationships in constitutional federal states.’\textsuperscript{127} In \textit{Costa}, and \textit{Internationale Handelsgesellschaft}, the court ruled that constitutional law is not capable of placing substantive limits on the expansion or application of EU law.\textsuperscript{128} In \textit{Foto Frost}, the ECJ asserted itself to be the final arbiter of what powers have and have not been conferred on the Union.\textsuperscript{129}

Under this ‘absolute’ conception of supremacy, Member State \textit{Kompetenz-kompetenz} has been criticised as an ‘anachronistic idea’ invoked under the ‘guise of protecting democracy.’\textsuperscript{130} Scholars such as Habermas, and Pernice, for example, argue that ‘National Courts are not authorised to monitor the limits of the transfer of national sovereign rights to the European level.’\textsuperscript{131} This is so ‘even in the case of a conflict with the very substance of fundamental rights’ and even if the European law is ‘found to violate such fundamental rights or to be \textit{ultra vires}.’\textsuperscript{132}

There is no explicit Treaty basis for this doctrine.\textsuperscript{133} It is instead established on the basis of two teleological doctrines of ECJ jurisprudence - one constitutional and one normative:

The first (constitutional) justification for the doctrine of supremacy holds, in essence, that the conferral of powers by the ‘\textit{peoples} of Europe’ (Articles 1, 3(1) TEU) adds up to much the same

\textsuperscript{126} \textit{Van Gend en Loos} \textit{v ENEL}. Supremacy even implies that EU legislation which is within its competences can affect national legislation outside its competences: \textit{Simmenthal}; Case C-287/98 \textit{Luxembourg v Berthe Linster and Others} [2000] ECR 1-6917.

\textsuperscript{127} \textit{Weiler}, 'The Transformation of Europe' (1990-1991), 2413. Direct effect distinguishes EU law from international law, under which national law is left to choose the method and effect of legal norms within its territory (if any). See also: Lenaerts, 'Many Faces of Federalism' (1990); Koen Lenaerts, 'Federalism: Essential Concepts in Evolution - the Case of the European Union' (1997) 21 Fordham Int'l Law J 746, 778.


\textsuperscript{129} In \textit{Foto-Frost}, the ECJ ruled that it has the exclusive competence to adjudicate on the legality of EU acts, including ‘on grounds of lack of competence’, and no constitutional constraint may stand in the way of this assessment. See also: Case C-376/98 \textit{Germany v Parliament and Council (Tobacco Advertising)} [2000] ECR 1-8419.

\textsuperscript{130} Jo Eric Khushal Murkens, “‘We want our identity back” - the review of national sovereignty in the General Federal Constitutional Court’s decision on the Lisbon Treaty' (2010) 10 PL 530, 542. See also: Mattias Wendel, ‘Exceeding judicial competence in the name of democracy: The German Constitutional Court’s OMT Reference’ (2014) 10 EuConst 263, 274.

\textsuperscript{131} Jürgen Habermas, \textit{The Crisis of the European Union: A Response} (Polity Press 2012), 25.

\textsuperscript{132} Pernice (1999), 719.

\textsuperscript{133} The case-law establishing primacy of EU law has been confirmed in Declaration No 17 concerning primacy [2012] OJ C 325/345 attached to the Lisbon Treaty, which cites the following Opinion of the Council Legal Service: ‘At the time of the first judgment of this established case law (Costa/ENEL, 15 July 1964, Case 6/641) there was no mention of primacy in the treaty. It is still the case today. The fact that the principle of primacy will not be included in the future treaty shall not in any way change the existence of the principle and the existing case-law of the Court of Justice.’ For an examination of the implications of the fact primacy was deleted from the Treaty at the Lisbon intergovernmental conference, see: De Witte, 'The Nature of the Legal Order' (2011), 345.
thing as a single ‘people of Europe’, and the supremacy of EU law may now claim to derive from an autonomous source of legitimation that supersedes the national impulse to claw-back disputed territory.\textsuperscript{134} This can be seen in the ‘sovereignty building’ cases of the 1960’s, wherein he ECJ justified supremacy by the direct connection between the peoples and the Union.\textsuperscript{135} European monist scholars argue that the Parliament, based on a majority of the citizens of Europe, now provides a direct connection between a constituent people of Europe and EU law, not intermediated by national authorities.\textsuperscript{136} Pernice, for example, argues that by constituting a European people in a European Parliament, the ‘primacy of European law …. is founded on the common decision of the peoples of the Member State’, and ‘the European Parliament has resolved that primacy of Community law shall not be questioned by national Courts:’

‘[T]he founding treaties as well as each amendment agreed upon by the governments appear as the direct expression of the common will of the peoples of the Union… such treaties can be regarded, therefore, as a common exercise of constitution-making power by the peoples of the participating State.’\textsuperscript{137}

The second justification for supremacy is a normative one: the effective and uniform application of EU law.\textsuperscript{138} This finds its most forceful expression which it is couched in terms of the ‘rule of law,’\textsuperscript{139} ‘legal certainty,’\textsuperscript{140} or the ‘coherence of the EU legal order.’\textsuperscript{141} On this teleology, a failure to secure the normative imperative of the uniformity and effectiveness of EU law is an existential threat to the

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\textsuperscript{134} See: Pescatore (1970), 170, referring to ‘the creation of a genuine parliamentary influence’ and ‘majority procedures as a result of which it has been possible to form a common will.’ Sometimes, a ‘common decision of the peoples of Europe’ see: Pernice (1999) 717-723.

\textsuperscript{135} See, e.g., Costa v ENEL (the Member States ‘have thus created a body of law which binds both their nationals and themselves’); Van Gend en Loos (‘this Treaty is more than an agreement which merely creates mutual obligations between [states]’ the EEC constitutes a new legal order, the subjects of which ‘comprise not only the Member States but also their nationals.’); Case C-2/13 Opinion on Accession to the ECHR (Opinion of the Court of Justice, 18 December 2014) [157] (‘the subjects of which comprise not only those States but also their nationals.’).

\textsuperscript{136} Similarly, the Council (when voting in configurations other than unanimity) is no longer an assembly of Member States, in so far as one Member State cannot unilaterally decide which laws will apply in its territory. This was supported by the introduction of citizenship at Maastricht: Article 9 TEU. See: Pernice (1999) 717-723; Frederico Mancini, ‘The Making of a Constitution for Europe’ (1989 ) 26 CMLR 595; Lenaerts, ‘Many Faces of Federalism’ (1990), 224 Peter Hay, ‘The Contribution of the European Communities to International Law’ (1969) 59 Proceedings of the American Society of International Law 195, 196; Armin von Bogdandy and Jurgen Bast, The European Union’s Vertical Order of Competences: The Current Law and Proposals for its Reform’ (2002) 39 CMLR 227, 237; Lenaerts, 'Federalism' (1997), 754

\textsuperscript{137} Pernice (1999), 717-719 (emphasis added).


\textsuperscript{139} See Costa v ENEL: ‘[The Treaty] which is subject to no reservation, would be quite meaningless if a state can unilaterally nullify its effects by means of a legislative measure which could prevail over Community law.’

\textsuperscript{140} See Foto-Frost [15]-[19]: ‘Divergences between courts in the Member States as to the validity of Community acts would be liable to place in jeopardy the very unity of the Community legal order and detract from the fundamental requirement of legal certainty.’

\textsuperscript{141} See Commission v Luxembourg [38]: ‘to restrict the scope of the provisions of Community law would have the effect of impairing the unity and efficacy of that law.’ This is so even if the law is a directive: Kreil.
entire European legal order as a whole.\textsuperscript{142} This concern has comprised the normative basis for supremacy since\textit{Internationale Handelsgesellschaft}, where the court stated:

‘[T]he law stemming from the Treaty, an independent source of law, cannot … be overridden by rules of national law, however framed … without the legal basis of the Community itself being called into question. Therefore the validity of a Community measure or its effect within a Member State cannot be affected by allegations that it runs counter to either fundamental rights as formulated by the constitution of that state or the principles of a national constitutional structure.’\textsuperscript{143}

1.1.2 The Federation of Sovereign States

In proclaiming autonomy and supremacy over all constitutional law, Europe’s judges enunciated a form of ‘federalism.’\textsuperscript{144} However, the inability to reconcile this with European constitutional theory meant, as Schütze writes, ‘In the absence of a federal theory beyond the State, European thought invented a new word - supranationalism - and proudly announced that the European Union to be\textit{sui generis}.’\textsuperscript{145}

Yet while this ‘\textit{sui generis}’ claim pretended to reconcile two separate, sovereign constitutional orders, the hierarchy it enunciated was, in fact, a unitary (monist) legal order.\textsuperscript{146} This was so because the ECJ ‘arrogated to itself the ultimate authority to draw the line between Community law and national law.’\textsuperscript{147} By denying the \textit{peoples} of the Member States the right to choose which powers they had or had not conferred on the Union, it denied the sovereignty of those peoples and in fact subjugated them under a single (monist) legal order.\textsuperscript{148} Judge Schiemann, for example, dismisses defenders of Member State sovereignty by accusing them of ‘much the same instinctive defensive reactions as asking questions about a man’s virility.’\textsuperscript{149}

\textsuperscript{142} See: Pescatore (1970), 181 (the introduction of the concepts of international law ‘poses a real threat to the existence of the features which make the originality and strength of Community law’); Lenaerts, ‘Federalism’ (1997), 777 (‘if the regulations of the component entities were to prevail, the uniformity and effectiveness of the rules laid down by the central authority in areas of its own competence would be endangered, as would the federation itself.’)

\textsuperscript{143}\textit{Internationale Handelsgesellschaft} [3]; \textit{Costa v ENEL}, 594.

\textsuperscript{144} See Lenaerts, ‘Federalism’ (1997) 751. See also Sweet (2011), 132: these doctrines ‘reconstituted the EU as a quasi-federal legal system, comparable to other federal systems.’

\textsuperscript{145} Schütze (2015), 44. In \textit{Accession to the ECHR} [157] for example, the ECJ described the EU Treaties as ‘a new kind of legal order, the nature of which is peculiar to the EU, its own constitutional framework and founding principles.’


\textsuperscript{147} Stein (1981), 1. The CJEU has exclusive competence to invalidate EU law on grounds of competence: Case 66/80 Spa International Chemical Corp. v Amministrazione delle Finanze dello Stato [1981] ECR 1191; \textit{Foto-Frost}.

\textsuperscript{148} MacCormick, ‘Beyond the Sovereign State’ (1993), points out: ‘the upshot of that line of thought seems necessarily to be that we embrace the theory of Community sovereignty and accept that Member State governments are now substantially but the delegates of the Community.’ See also: Xavier Groussot, ‘Supr[imacy à la Française: Another French Exception’ (2008) 27 YEL 89 114, criticising Pernice (1999).

The purpose of Europe’s *sui generis* constitutionalism claim was therefore not to bridge the ‘apparent conflict between European constitutionalism and the constitutionalism of the Member States.’\(^{150}\) It was to establish, as Judge Maduro so put it, that ‘there is no *a priori* higher claim of validity for national constitutionalism *vis-à-vis* European constitutionalism.’\(^{151}\) As the Italian *Corte costituzionale* noted, the ECJ ‘certainly considers that the source of legal norms of the Community and that of each Member State are founded on a single system.’\(^{152}\) This was the point raised by MacCormick:

‘If system \(x\) enjoys supremacy over system \(y\), why trouble to have a theory about separate systems, rather than a theory which acknowledges the fact that \(y\) belongs to \(x\) as a sub-system of it?’\(^{153}\)

This assertion, that the sovereignty of the *peoples* of Europe existed only in so far as the ECJ had not yet ruled on the extent of their competences, led to irreconcilable tensions with persisting Member State sovereignty at the boundaries of EU law.

First, the declaration that the EU derived from its own autonomous *Grundnorm* declaration didn’t simply deprive the Member States of their own. EU constitutionalism had not emerged from an act of a European *people*, but from the acts of public authorities – ‘governments, legislatures, courts(!)’\(^{154}\) Applying basic principles of constitutional theory, scholars found that it was, ‘difficult – if not impossible to accept that “the founding treaties as well as each amendment agreed upon by the governments” appear as the *direct expression* of the corresponding will of the peoples of the Union.’\(^{155}\) Constitutional courts agreed.\(^{156}\) The EU was not a federal state, but a federation of sovereign states (*Staatenverbund*);\(^ {157}\) not a constitutional state, but a ‘constitutional order of states’;\(^ {158}\) it had not an historically-first constitution, but a ‘composite constitution’

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151 Miguel Poiares Maduro, ‘Europe and the constitution: what if this is as good as it gets?’ in JHH Weiler and Marlene Wiind (eds), *European Constitutionalism Beyond the State* (Cambridge University Press 2003) 74.
155 Schütze (2015), 56. See also Schilling (1996), 394: ‘there is no indication that the European treaties might have been a constitution ordained by a constituent power of the Community.’ See further, Weiler, ‘Europe’s constitutional Sonderweg’ (2003), 7, 9: ‘Simply put, Europe’s constitutional architecture has never been validated by a process of constitutional adopt by a European constitutional demos.’
156 As national Constitutional Courts have been keen to assert, it is the Member States which are the ‘Masters of the Treaties.’ See, e.g., Germany: *Brunner (Germany)* [55]; *Re Lisbon (Germany)* [207], [247], [274]; *Re Honeywell (BVerfGE)* [42]; *Gauweiler I (Germany)* [26]. Czech Republic: *Lisbon I (Czech Republic)* [146]. Poland: *Lisbon (Poland)* [3.8]. Spain: *Maastricht (Spain)* DTC 1/1992 of 1 July 1992 (English version available at: <http://wwwtribunalconstitucionales> accessed 23 June 2015) (*Tribunal Constitucional de España*) [4].
157 *Re Lisbon (Germany)* [205] (‘a long-term association of states which remain sovereign’); *Re Honeywell* (Case 2 BvR 2551/06): BVerfGE 126, 286; [2011] I CMLR 33 (*Bundesverfassungsgericht*) [47].
(Vergassungsverbund).\textsuperscript{159} The German BVerfGE,\textsuperscript{160} the French Conseil d'État,\textsuperscript{161} the French Conseil Constitutionnelle,\textsuperscript{162} the Italian Corte Constituzionale,\textsuperscript{163} and the Spanish Tribunal Constitutional\textsuperscript{164} all explicitly denied the sovereignty of the European Parliament in their first encounters with the claim - it was not founded by a pouvoir constituent originaire, but bound within competences set by international Treaty.

Second, the institutional systems of the EU were not wholly supranational,\textsuperscript{165} not wholly unknown to international law as claimed,\textsuperscript{166} and those aspects which were supranational were not wholly democratic.\textsuperscript{167} The Council and Commissioners, for example, hold their positions ‘only by reference to the place they hold according to state-systems of law.’\textsuperscript{168} The sole institution intend to embody a European people, the European Parliament, is bestowed with the weakest influence on the programme of legislation and circumscribed by Treaty.\textsuperscript{169} How could it be accepted that, on one hand, each EU norm is the direct expression of a European people, and yet, on the other ‘the Community legislator does not receive any direct electoral mandate’?\textsuperscript{170}

Third, in the absence of a European demos,\textsuperscript{171} a deficit of democratic legitimation at EU level,\textsuperscript{172} and the lack of a Treaty basis for supremacy,\textsuperscript{173} ‘nearly all of the appellate courts balk at the claim of the

\textsuperscript{159} A composite composition made up by ‘the Constitutions of the Member States bound together by a complementary constitutional body.’ Pernice, 'Multilevel Constitutionalism' (1999), 707 (emphasis added).

\textsuperscript{160} Brunner (Germany) [55]; Re Lisbon (Germany) [205].

\textsuperscript{161} ‘The election by direct universal suffrage of the representatives of the peoples of the member States to the [European] Parliament does not have the effect of creating either a sovereign body or institutions whose nature would be incompatible with respect for national sovereignty.’ Re Elections to the European Parliament (France) [1978] RGDIP 616 (original French); [1978] 74 ILR 527, in Oppenheimer, The Cases (Vol 1) 314 (Conseil d'État), 315.

\textsuperscript{162} Re Maastricht I (France) [32]-[34]; Re Elections to the EP (France), 316.

\textsuperscript{163} Frontini v Ministero delle Finanze (Italy) Decision No 183/1973 (27 December 1973); [1974] 2 CMLR 372.

\textsuperscript{164} Constitutional Treaty (Spain).

\textsuperscript{165} The European Council and the Commission are appointed by Member States.

\textsuperscript{166} ‘Law-making’ treaties are not unknown to international law, and supremacy is a well-established principle of international law. Weiler, 'Does Europe Need a Constitution?' (1995), 220 observes: ‘This is somewhat embarrassing given the orthodoxies of European constitutionalism a centrepiece of which is its claim to constitute a new legal order which cut its umbilical cord from international law.’ See also: Schilling (1996), 396-340 (supremacy does not make EU law unique).

\textsuperscript{167} In particular, the EU’s conception of democracy does not conform to that required in some national constitutions, in particular, Art 38(1) of the German Basic Law: Re Lisbon (Germany) [264], concluding (according to the German definition of democracy): ‘if measured against the principle of representative democracy, however, [the EU] would show an excessive degree of federalisation.’ (See Section 1.1.3.2).

\textsuperscript{168} ‘This presupposes and recognises the validity of the legal system of each of the Member States: MacCormick, 'Soevereignty Now' (1995), 264.

\textsuperscript{169} Grimm (1995), 294-296 notes: European state ‘could not meet the democratic requirements of the present’ and its level of legitimation was seen as ‘lower than a nation-States.’


\textsuperscript{171} See: Weiler, 'Europe's constitutional Sonderweg' (2003).

\textsuperscript{172} See: Grimm (1995), 294-296;

\textsuperscript{173} Schilling (1996), 397, describing ‘unacceptable interpretations of the original treaties.’
claim of the ECJ that the European treaties are the constitutions of an autonomous legal order. ᵃ In a body of jurisprudence beginning with the Italian ‘controlimitt’ doctrine and the German Solange and Brunner v EU Treaty decisions, constitutional courts asserted that EU supremacy took effect not as an autonomous constitutionalism, but as a normative principle of national constitutional law. ᵃ The Brunner v EU Treaty (Germany) decision is perhaps the best-known in that regard:

‘The Federal Republic of Germany, therefore, even after the Union Treaty comes into force, will remain a member of a federation of States, the common authority of which is derived from the member-states and can only have binding effects within the German sovereign sphere by virtue of the German instruction that its law be applied. Germany is one of the ‘Masters of the Treaties’, which have established their adherence to the Union Treaty … but could also ultimately revoke that adherence by a contrary act. The validity and application of European law in Germany depends on the application-of-law instruction of the Accession Act. Germany thus preserves the quality of a sovereign State in its own right…’ ᵃ

In federal constitutions where doctrines of supremacy arise, they typically only do so only where the doctrines of federal supremacy, ᵃ and federal adjudication, ᵃ are explicitly prescribed in the provisions of an ‘original constitution’ by a pouvoir constituent, and in which the amending power is at federal level. ᵃ Only one of these conditions apply within the scope of EU’s competences, and none of them apply outside them. ᵃ National constitutional courts pointed out that the same

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¹⁷⁵ Frontini (Italy); Internationale Handelsgesellschaft MbH (Soleande J) (Germany) (Case 2 BvL 52/71: BVerfGE 37, 272; [1974] 2 CMLR 540 (Bundesverfassungsgericht) [59]-[60]; Brunner (Germany).
¹⁷⁶ Brunner (Germany) [55].
¹⁷⁷ Switzerland: Constitution of Switzerland, Art 51(2): ‘Each cantonal constitution shall require the guarantee of the Confederation. The Confederation shall guarantee a constitution provided it is not contrary to federal law.’ The US: Constitution of the United States, Art VI: ‘The Constitution, and the Laws of the United States … and all Treaties made … shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.’ Canada: Constitution Act 1982, s 52, under which a law that is contrary to any provision of the Constitution of Canada is ‘of no force or effect’.
¹⁷⁹ Weiler, ‘Europe's constitutional Sonderweg’ (2003), 8; Bermann (1994), 45. See also: Lenaerts, 'Many Faces of Federalism' (1990), 235, concluding that the high degree of Cantonal checks on Confederate power in Switzerland compensates for ‘a vacuum in their judicial protection against an excessive use by the federal legislative of its enumerated powers.’
¹⁸⁰ Federal supremacy is not written in the Treaties and the amending power is not at federal level. However ‘federal’ adjudication is given to the CJEU under Art 263 TFEU: ‘The [CJEU] shall … have jurisdiction in actions brought by a
confederate foundations which constrain the EU order also apply to its court - it a creature of the Treaties bound within its competences (and capable of acting ultra vires).\textsuperscript{181} In Brunner (Germany), the BVerfGE held:

‘An interpretation of which would give the Union a power to extend its powers would also contradict the consistently expressed intention of the Contracting Parties to define by Treaty provisions the principle of restricted specific empowerment and to set clear limits to individual rules conferring powers. If [the Treaty] were the basis for a power to take powers, it would cut across the whole system of competences under the Union Treaty … and make them largely meaningless.’\textsuperscript{182}

This assertion of sovereignty deprived European (monist) constitutionalism of its normative power because, as Maduro admits, ‘a different perspective is taken by national legal orders and national constitutions [requiring] a conception of the law which is no longer dependent upon a hierarchical construction.’\textsuperscript{183} It also deprived it of its descriptive power because, as Solange (Germany), Brunner (Germany), Frontini (Italy) and their progeny made clear, the ultimate authority over the validity of EU law in constitutional orders remained national constitutional courts. As Weiler observes:

‘Early “Europeanists” liked to argue that the Grundnorm ... had shifted to the “central” or “general” power: That is, to Europe. That view is less in fashion today and is contested by those who point out that, both in fact and in law, ultimate authority still rests in national constitutional orders which sanction supremacy, define its parameters, and typically place limitations upon it.’\textsuperscript{184}

1.1.3 Constitutional Pluralism

Constitutional pluralism may now be said to have several strands,\textsuperscript{185} but the central tenet is that it departs from the Kelsenian emphasis on the locus of sovereignty for a Hartian ‘rule of reason’

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Member State, the European Parliament, the Council or the Commission on grounds of lack of competence...’ Cf: Bermann (1994), 453.

\textsuperscript{181} See, e.g., Case C-399/09 Landtová v Česká práva socialního zabezpečení [2011] ECR I-05573 (explicitly ruling a decision of the ECJ ultra vires); European Arrest Warrant (2 BvR 2735/14) (Germany) (Case 2 BvR 2735/14) available at: <www.bundesverfassungsgericht.de> accessed 22 May 2016 (Bundesfervassungsgericht) (implicitly ruling a decision of the ECJ ultra vires); Gauweiler III (Germany) (implying that the ECJ decision in Gauweiler v Deutsche Bundestag was ultra vires, but that the breach was not ‘manifest’).

\textsuperscript{182} Brunner (Germany) [66], [99], adding: ‘Such an interpretation is also contradicted by [the Treaty], which excludes any implied amendment of the existing Treaties by the Union Treaty.’

\textsuperscript{183} Maduro, ‘Europe and the constitution’ (2003), 95.

\textsuperscript{184} Weiler, ‘Europe's constitutional Sonderweg’ (2003), 13.

\textsuperscript{185} ‘Discursive pluralism’, accepts that competing formal authorities exist, and seek to describe the discursive process of resolving it: Maduro, ‘Europe and the constitution’ (2003); Miquel Poiares Maduro, ‘Contrapuntal Law: Europe's Constitutional Pluralism in Action’ in Neil Walker (ed), Sovereignty in Transition (Hart 2003); Groussot (2008). Liberal constitutional pluralism concentrates on the validity and reality of constitutional claims: Kumm, 'Final Arbiter' (1999); Kumm, 'The Jurisprudence of Constitutional Conflict' (2005); Claes (2006); Claes (2015); Alan Dashwood and others (2011). In German jurisprudence, constitutional pluralism is encapsulated by the Vergassungsverbund, (literally, the ‘association of constitutions’), which has been described as a system of ‘reciprocal constitutional stabilisation’: Christoph Grabenwarter, ‘National Constitutional Law Relating to the EU’ in Armin von Bogdandy and Jürgen Bast (eds),
approach to describe European constitutionalism as a normative system of overlapping and interacting claims.\textsuperscript{186} Constitutional pluralism accepts that neither legal authority can abandon the legal order which it is has been charged to protect.\textsuperscript{187} The EU legal order is ‘pluralistic rather than monistic, and interactive rather than hierarchical.’\textsuperscript{188} Its benefit is that, in allowing theorists of EU law to ‘escape from the idea that all law must originate in a single power source,’ it provides a starting point for resolving conflicts of law in application.\textsuperscript{189}

While not all can agree that pluralism justifies the competing claims of European and national constitutionalism, there are few who disagree that it explains them.\textsuperscript{190} The virtue of constitutional pluralism lies in its ability to describe what courts \textit{will} do, rather than what they should do.

In that regard, the reality that matters for this thesis is that - as scholars on both sides of the divide admit - Member States will often have the ‘final say’ as arbiters of the boundaries of EU law.\textsuperscript{191} When applying MacCormick’s Hartian approach, ‘what matters … is that a conflict rule must be valid from the vantage point of the norm taken as reference point of the legal system in order to be regarded as a rule of that legal system.’\textsuperscript{192} On this approach, there are few jurists who would credibly argue that a declaration of invalidity by, say, the BVerfGE with regard to ECB’s OMT


\textsuperscript{187} MacCormick, \textit{Questioning Sovereignty} (1999), 118 explains: ‘it must be for the highest constitutional tribunal of each member States to interpret its constitutional and other norms … It must then follow that the constitutional court of a Member States is committed to denying that its competence to interpret the constitution by which it was established can be restricted by decisions of a tribunal external to the system.’ See also: Maduro, ‘Europe and the constitution’ (2003) at 99 argues that: ‘[N]o legal order should be forced to abandon its own viewpoint… I argued that national deviations can still be possible but they need to be argued in “universal” terms, safeguarding the coherence and integrity of the EU legal order.’

\textsuperscript{188} MacCormick, ‘Sovereignty Now’ (1995), 264: The doctrine of supremacy ‘is not to be confused with any kind of all-purpose subordination of Member State law to [Union] law.’

\textsuperscript{189} MacCormick, ‘Beyond the Sovereign State’ (1993), 8.

\textsuperscript{190} Pernice, ‘Multilevel Constitutionalism’ (1999), 713-714: in a multilevel or pluralistic federation, there is no legal criterion for settling the dispute, because no rule in one system can be a criterion for the validity of acts of the other. See also: Grabenwarter (2011), 129 the \textit{Vergessungsverband} is ‘not a normative category but an expression that describes the legal and factual interrelationships between constitutions … without creating a system of dependence like in federal states.’

\textsuperscript{191} Pernice, ‘Multilevel Constitutionalism’ (1999), 714: ‘The final say … though limited by the recognition of European integration in the national constitution, would be in the hands of those who ultimately have to implement European law: national administrations and national courts.’

\textsuperscript{192} Dyevre (2013), 147.
programme,193 or a European arrest warrant,194 would be ignored in Germany for a normative claim by the ECJ that another rule should be applied.195

This now accepted by Europe’s judges as an empirical matter, even if it is not admitted as a matter of doctrine.196 As Judge Maduro admits, while the doctrinal position is that EU law is the higher law, ‘National law still holds a veto power over EU law, and that is important even when it is not used.’197

Judge Lenaerts makes a similar admission:

‘Day after day … the [ECJ] must win the trust of Member States and national supreme courts as the “ultimate judicial umpire” of [Union] competences… The conceptual reason for this is rather straightforward: the Member States – and not the people as such – hold the Kompetenz-Kompetenz as makers of the constitution.’198

In any event, as will be shown, it is by the Treaty itself that EU law can only take effect to the extent that it is empowered ‘in accordance with [Member State] respective constitutional requirements.’199 This means that, whether one adopts a Kelsenian or a Hartian approach, it will necessarily be the national system which is ‘taken as starting point that will decide how conflicts are to be resolved and what the relevant conflict rules are.’200 As Maduro so puts it, ‘constitutional pluralism is what best describes the current legal reality,’ and it is on that basis that this thesis must proceed.201

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193 Gauweiler I (Germany); Gauweiler III (Germany) (placing the Bundesbank on notice to protect against the violation of six conditions set by the BVerfGE on the operation of OMTs).
194 EAW (2735/14) (Germany) (invalidating an EAW).
195 Maduro, 'Europe and the constitution' (2003), 96:‘Of course, in the operation of national constitutions and where constitutional review exists, it is expected that the legislator will accept the court’s decision and therefore it is stated that it is the latter which has the “right to decide who decides.”
196 Even Judge Schiemann (who compares the defense of sovereignty to defending ‘a man’s virility’) admits that while the CJEU works on the basis that it is up to the ECJ ‘to decide how much has remained in the hands of the State’, the reality of it is dependent on the ‘perspective of the law of a Member State or the law of the Community.’ Schiemann (2007), 487. Scholars and judges now refer to a ‘dialogue’ (Melloni (Spain) [1] per Batarrita J), to describe interactions between legal orders. See also: Jan Komárek, 'Federal Elements in the Community Judicial System: Building Coherence in the Community Legal Order' (2004) 42 CMLR 9; Armin von Bogdandy and Stephan Schill, 'Overcoming Absolute Primacy: Respect for National Identity under the Lisbon Treaty' (2011) 48 CMLR 1417, 1450; Groussot (2008).
197 Maduro, 'Europe and the constitution' (2003), 95, 97-98.
198 Lenaerts, 'Federalism' (1997), 787.
199 Arts 48(4) TEU, 49 TEU, 54 TEU, and 357 TFEU state that the EU acquires its competences upon ratification by the Member States in accordance with their respective constitutional requirements.’ See also: arts 42(2) TEU, 50(1) TEU, 25 TFEU, 223(1) TFEU, 262 TFEU, 311 TFEU, and Statute of the ESCB, art 40.2.
200 Dyevre (2013), 147. This is not only consistent with Kelsenian theory of sovereignty, but also with the ‘rules of change’, ‘rules of adjudication’ and rule of recognition for identifying norm-creating and decision-making competences which European sovereignty claims also depend on: Hart (1994) 92-107. See also: MacCormick, Legal Reasoning and Legal Theory (1978); MacCormick, 'Beyond the Sovereign State' (1993). For the point that EU monist depends on Hartian reasoning because it cannot satisfy the Kelsenian theory, see: Theodor Schilling, 'The Autonomy of the Community Legal Order: An Analysis of Possible Foundations' (1996) 37 Harv Int'l LJ 389, 398; and Mark L Jones, 'The Legal Nature of the Europen Community: A Jurisprudential Analysis using HLA Hart's Model of Law and a Legal System' (1984) 17 Cornell Int'l LJ 1. For the point that national (Kelsenian) sovereignty is also consistent with Hartian positivism, see: De Witte, 'Sovereignty and European Integration' (1998), ‘The principle of sovereignty is the apex of the constitutional systems of most European states; it acts, to borrow the language of HLA Hart, as the rule of recognition within those legal orders.’
1.2 The Constitutional Boundaries of the European Legal Order

1.2.1 The Ultra Vires Review Jurisdiction

The first limit imposed by national constitutional orders on EU law is that of competence. Member States profess to retain for themselves the competence to decide on competences - the so-called Kompetenz-kompetenz. This is asserted in two ways: Through the act of Treaty ratification itself (the so-called legislative kompetenz-kompetenz) and through ultra vires review by constitutional courts (the judicial kompetenz-kompetenz). The purpose of Section 1.2.1 is to establish this claim as a valid constitutional, normative and positive description of the limits of EU law for the purposes of this study.

1.2.1.1 Constitutional Evaluation of Member State Ultra Vires Review

Under Articles 4(1), 5(1) and 5(2) TEU, the limits of Union competence are governed by the principle of conferral, and under Articles 48(4) TEU, 49 TEU, 54 TEU, and 357 TFEU, the EU acquires its competences when the Treaties are ratified by the High Contracting parties in accordance with their respective constitutional requirements. The EU does not exist independently of the Treaties, and has no competences by right. Its powers are limited to those which are voluntarily conferred upon it by the Member States. The Union is ‘thus not “national” - that is: sovereign - in scope.’ As the BVerfGE has stated, ‘sovereignty under international law and public

202 Germany: Re Lisbon (Germany) [207]-[209], [215], [247], [274]; Brunner (Germany) [55]; Re Honeywell (BVerfGE) [42]; Gauweiler I (Germany) [26]. Czech Republic: Lisbon I (Czech Republic) [146]. Denmark: Hausgaard and Others v Prime Minister and Another (Lisbon) (Case 199/2012) [2014] 3 CMLR 16 (Højesteret (Supreme Court of Denmark)) [32]. Spain: Constitutional Treaty (Spain) [3]. Poland: ESM & TSCG (Poland) [6.3.3] (the States maintain ‘the competence of competences’). Italy: Frontini (Italy) [7]. France: Re Maastricht I (France) [32]-[34] (European Parliament is bound within the competences set by international Treaty). Portugal: European Regional Development Fund (ERDF) (Case No 184/89) of 1 February 1989, in Oppenheimer, The Cases (Vol I) 407 (Triunal Constitutional), 687-688. Belgium: European School v Hermans-Jacobs and Heuvelmans-van Iersel (Case No 12/94) of 3 February 1994, as translated in Oppenheimer, The Cases (Vol II) 155 (Cour d'arbitrage) [B.4]. UK: Thoburn v Sunderland City Council (UK) [2002] 4 All ER 156 (UK House of Lords) [69]. per Laws L.J. Latvia: Re Lisbon (Latvia) (Case No 2008-35-01) of 7 April 2009 (English version available at: <http://www.satviesagovlv> accessed 17 July 2016) (Satversmes tiesa (Constitutional Court)), 52-53.

203 The legislative kompetenz-kompetenz can be described as the legislative power to determine the legitimate scope of competence. For national orders this means that there can be no application of EU law outside of the national constitutional empowerment. Groussot (2008), 92; Jo Shaw, 'Europe's Constitutional Future' (2005) PL 132, 142; Pernice, 'Multilevel Constitutionalism' (1999), 519.

204 Judicial kompetenz-kompetenz refers to the formal constitutional authority to adjudicate on the limits of the national constitutional empowerment. Kunn, 'Final Arbiter' (1999), 380; Groussot (2008), 93.

205 Art 4(1) TEU: ‘competences not conferred upon the Union in the Treaties remain with the Member States.’

206 Art 5(1) states: ‘The limits of Union competences are governed by the principle of conferral.’

207 Art 5(2) states: ‘Under the principle of conferral, the Union shall act only within the limits of the competences conferred upon it by the Member States in the Treaties to attain the objectives set out therein. Competences conferred upon the Union in the Treaties remain with the Member States.’

208 Art 48(4) TEU (Ordinary revision procedure); Art 49 TEU (accession procedure); Art 54 TEU (ratification of the TEU); Art 357 TFEU (ratification of the TFEU). See also: Art 42(2) TEU (decision common defence); Art 50(1) TEU (unilateral withdrawal); Art 25 TFEU (amendment of rights); Art 223(1) TFEU (amendment of parliamentary election period); Art 262 TFEU (jurisdiction in IP rights); Art 311 TFEU (amendment of own resources).

209 See, e.g., ESM & TSCG (Poland) [6.3.3]: the Member States ‘maintain “the competence of competences” and the model of European integration is a form of international organisation.’

law requires independence from an external will precisely for its constitutional foundations." 211 Other constitutional courts (including, at times, the ECJ) 212 reach similar evaluations of EU constitutionalism. 213 Whether or not there is yet a single European demos behind the exercise of EU power, it is beyond refute that the democratic legitimation for the bestowal of the EU’s powers flows from Member State constitutional orders. As constitutional courts have been keen to assert, it is the Member States which are the ‘Masters of the Treaties.’ 214

In this respect, the EU is unlike other federations examined in this thesis, where the source of federal power is the revolutionary act of a common pouvoir constituant. The preamble to the US Constitution, for example, refers to ‘We the People of the United States’ which ‘do ordain and establish this Constitution.’ 215 The TEU, by contrast, refers to the High Contracting Parties (not people) establishing an ever closer Union of the peoples (not people) of Europe on which the Member States (not people) confer (not ordain) competences by Treaty (not Constitution). 216

The EU is ‘federation of sovereign states’ (Staatenverbund) to which sovereign powers are transferred. 217 Without the limits of conferral, entering into the Union would have been unconstitutional in all 27 of Europe’s constitutional democracies (with one qualification) 218 reviewed in this chapter. 219 The EU’s powers are carved out from Member State constitutions and, nemo plus

211 Re Lisbon (Germany) [207].
212 ‘The EU is, under international law, precluded by its very nature from being considered a State.’ Case C-2/13 Opinion on Accession to the ECHR (Opinion of the Court of Justice, 18 December 2014).
213 Denmark: Hausgaard (Denmark) [32] (‘[T]he [EU] is still an organisation consisting of independent, mutually obliged States functioning based on powers delegated by each Member State.’ Spain: Constitutional Treaty (Spain) [3]. ESM & TSCG (Poland) [6.3.3] (Member States maintain ‘the competence of competences’). Italy: Frontini (Italy) [7]. France: Re Maastricht I (France) [32]-[34] (European Parliament not sovereign because it is not founded on a pouvoir constitutif originaire, but is bound within the competences set by international Treaty). Portugal: ERDF (Portugal), 687-688 ‘there can be no exercise of the regulatory power without some basis in a lex anterior. Belgium: European Schools (Belgium) [B.4] (‘no rule of international law, which is the creation of States, not even Article 27 of the Vienna Convention of 1969 … gives the power to States to conclude treaties which are contrary to their Constitutions’). UK: Thorburn v Sunderland CC (UK) [69], per Laws LJ (‘there is nothing … which allows the [European Court] or any other institutions of the EU, to touch or qualify the conditions of Parliament’s legislative supremacy in the United Kingdom’). Latvia: Re Lisbon (Latvia), 52-53 (‘The exercise of power by the Union appears not as the will of a single sovereign … the Member States confer competencies to attain objectives they have in common.’).
214 Brunner (Germany) [55]; Re Lisbon (Germany) [207], [211], [247], [274]; Re Honeywell (BVerfGE) [42]; Gauweiler I (Germany) [26]; EAW (2735/14) (Germany) [I 2(b)]. Lisbon I (Czech Republic) [146]; Poland: Lisbon (Poland) [3.8].
217 Re Lisbon (Germany) [205]: ‘a long-term association of states which remain sovereign.’
218 In the Netherlands, EU law takes effect by virtue of the national parliamentary empowerment of ratification, and so there can be no application of EU law without a parliamentary conferral of competence. However, the Dutch courts are prohibited from reviewing the constitutionality of Treaties. This has led to a debate among Dutch constitutional scholars as to whether EU law could apply outside the constitutional empowerment. See: Claes (2006), 214; Monica Claes and Bruno de Witte, ‘The European Court and National Courts - Doctrine and Jurisprudence: Legal Change in its Social Context. Report on the Netherlands’ (1996) Eur Univ Inst Working Papers No 26.
219 See, e.g., Germany: Re Lisbon (Germany) [204]-[205] ‘The Basic Law does not grant powers to bodies acting on behalf of Germany to abandon the right to self-determination of the German people in the form of Germany’s sovereignty under international law by joining a federal state.’ Poland: Accession Treaty (Poland), grounds 1-5; Lisbon (Poland), grounds 2.1, 2.2, ‘Within the meaning of the Constitution, it is possible to confer competences “in relation to
iuris, none of Europe’s constitutional democracies allow the disposition of the constitutional amending power by conferring Kompetenz-Kompetenz on the Union. The ruling of the Spanish Tribunal Constitucional in Maastricht (Spain) is characteristic:

‘[U]nder Section 93 (Spanish Constitution), the Spanish parliament can grant or transfer the exercise of “powers derived from the Constitution”, but cannot dispense with the Constitution itself, contravening or permitting the contradiction of its provisions. The possibility of amending the Constitution is not a “power” whose exercise can be granted.’

In any event, the principle of democracy is a foundational principle of the European Union, and Articles 5 TEU, 48(4) TEU, 49 TEU, 54 TEU, and 357 TFEU are quite clear on the manner of democratic legitimation for the acquisition of competence: the Treaties must be ratified by the Member States ‘in accordance with their respective constitutional requirements.’ Thus, even if one accepts the pure constitutional justification for supremacy – that the conferral of powers by the ‘peoples of Europe’ adds up to much the same thing as a single constitutional ‘people of Europe’ - it remains that this legitimation can only ever flow within the limits of the EU’s conferred powers. If supremacy is ‘founded on a common decision’ by a European people, then that ‘common decision’ was to resolve - by writing Articles 5 TEU, 48(4) TEU, 49 TEU, 54 TEU, and 357 TFEU into the Treaties - that the EU cannot extend its own powers in any way that violates Member State constitutional law. Whether one looks from the viewpoint of EU (monist) constitutionalism or (national) constitutional democracy, the constitution requires the same thing: An act of conferral

certain matters” which excludes conferral of competence to determine competences.’ Denmark: Carlsen (Denmark) [15], section 20 of the Danish Constitution ‘precludes that it can be left to the international organisation to make its own specification of its powers.’ Czech Republic: Lisbon I (Czech Republic) [145], ‘if the Union could change its competences at will, independently of the signatory countries, then by ratifying the TL the Czech Republic would violate Art 1 [and] Art. 10a of the Constitution.’ Ireland: Croity (Ireland), 783, ‘If it is now desired to qualify, curtail or inhibit the existing sovereign power… it is not within the power of the Government itself to do so’). France: The transfer of powers in areas other than those already provided for under the constitution require the constitution to be amended: Re Maastricht I (France) [44]-[50]; Re Constitution for Europe (France) Decision No 2004-505 DC (19 November 2004) (Conseil Constitutionnel) [24], [29]; Loi relative au droit d'auteur et aux droits voisins dans la société de l'information Decision No 2006-540 DC (27 July 2006) (Conseil Constitutionnel) [19]; Re Lisbon (France) [9], [16]-[18], [20]. Loi sur l'intégration de l'immigration et de la citoyenneté (France) Decision No 2011-631 DC (9 June 2011) English version available at: <http://wwwconseil-constitutionnelfr> accessed 20 June 2013 (Conseil Constitutionnel) [9]; TSGC (France) [16]. Spain: Maastricht (Spain) [4], ‘the possibility of amending the Constitution is not a “power” whose exercise can be granted.’

European Schools (Belgium) [B.4] is demonstrative: ‘the Constituent Assembly, which has forbidden the legislature to pass rules contrary to those referred to by [Art 143] of the Constitution, may not be supposed to have authorised the same legislature to do so indirectly through the assent given to an international Treaty.’

Maastricht (Spain) [3e], [4]; Constitutional Treaty (Spain) [4].

Arts 2, 10 TEU.

See also: Art 42(2) TEU (decision on a common defence); Art 50(1) TEU (unilateral withdrawal); Art 50(1) TEU (amendment of the rights in Art 20(2) TFEU); Art 223(1) TFEU (amendment of parliamentary election period); Art 262 TFEU (conferral of jurisdiction in intellectual property rights); Art 311 TFEU (amendment of own resources); Art 40.2 Statute of the ESCB.

Declaration No. 17 Concerning Primacy does not make the supremacy of EU law absolute. It may apply only within the powers conferred. See: Re Lisbon (Germany) [216], [307]-[308]; Re Honeywell (BVerfGE) [38]-[40], [42]; Constitutional Treaty (Spain) [3]; Re Elections to the EP (France), 315.
under national constitutional law. As asserted by the Spanish Tribunal Constitucional, ‘the primacy set forth according to the Treaty … is reduced expressly to the exercise of competences attributed to the European union … it is not a primacy with a general scope,’ Article 5 TEU "acknowledges, as plainly as can be, that the Community’s powers are, in principle limited. The notion of a Community continuously moving the boundary posts of its own competence is ruled out of court." Moreover, this appropriation is permanent: Because the supremacy of EU law applies within the scope of the EU’s competence, the establishment of this ‘new’ EU competence permanently switches the power to determine law in that area from the Member State to the Union. The peoples of the Member States which did not vote on this transfer will have forever lost the capacity to correct this error, whether by statute or constitutional amendment. As the BVerfGE warns, an ECJ Kompetenz-kompetenz would mean that ‘the power to dispose of the fundamental aspects of the Treaties would be shifted [to the institutions of] the European Union, that their understanding of the law could result in an amendment of a Treaty or in an expansion of powers.’ This must, by definition, result in the reductio ad absurdum of Articles 4(1), 48(4), 49, and 54 TEU upon which the democratic legitimation of EU power is based, to say nothing of popular sovereignty under national constitutional law.

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225 As stated by the Tribunal Constitucional: ‘The supremacy of the Constitution is compatible with application systems which confer priority to the application of norms of other legal systems … because the Constitution provides for it.’ Constitutional Treaty (Spain) [4].

226 Constitutional Treaty (Spain) [3] (emphasis added). See also: EAW (2735/14) (Germany) [1 2(b)].


228 See, for this point: Re Lisbon (Germany) [214]. This may have severe consequences where EU law shares a boundary with national constitutional identity: Gauweiler III (Germany) [86] (noting that the monetary competence of the ECB borders with the Member States’ responsibility for fiscal policy, and an excess of this competence may therefore infringe on the democratic content of the budgetary powers of the state in violation of Articles 38(1), 20(2),(2) and 79(3) BL).


230 There is no provision allowing the Union to confer a power without a total revision of the Treaties, even if the mistake is broadly recognised. The EU’s competences may be amended by unanimity under Art 48 TEU, but national constitutional rules differ, and one state may be pleased to discover that it may now participate in the exercise of a power which would have been unconstitutional to confer in 27 others. Direct taxation, border security, price stability, are all competences in which constitutional law and political opinion differ significantly between Member States. See: Wyatt (2011), 5, ‘few Member States exercised self-restraint where Community action pursued policies in line with national political priorities.’

231 Gauweiler I (Germany) [26].
For this reason, the German BVerfGE has long held that it has an *ultra vires* review jurisdiction to decide whether the EU has stepped over the boundaries given to it.\(^{232}\) According to the court, an expansive interpretation of EU law in a manner ‘equivalent to an extension of the Treaty … would not produce any binding effects for Germany’ and, if the transgression could not be remedied, require the withdrawal from the Union altogether.\(^{233}\) In *Re Lisbon (Germany)*, the BVerfGE held:

‘Faith in the constructive force of the mechanism of integration cannot be unlimited. If in the process of European integration primary law is amended, or expansively interpreted by institutions, a constitutionally important tension will arise with the principle of conferral and with the individual Member State’s constitutional responsibility for integration. … They are moving on a road at the end of which there is the power of disposition of their foundations laid down in the treaties, i.e. the competence of freely disposing of their competences. There is a risk of transgression of the constitutive principle of conferral and of the conceptual responsibility for integration incumbent upon Member States if institutions of the European Union can decide without restriction, without any outside control, however restrained and exceptional, how treaty law is to be interpreted.\(^{234}\)

The BVerfGE is far from alone. The constitutional bases and jurisprudence relating to the application of EU law from each of the 27 Member States can be catalogued here only in brief. However, suffice it to state here that no Member State constitutional authority accepts the autonomous constitutional supremacy of EU law, and all exercise some jurisdictional control over the *kompetenz-kompetenz* of the *constituent pouvoir originaire*:

In **Italy**, the *Corte costituzionale* exercises *a posteriori* control over the Act of Accession and the expansion of EU law under its ‘*controlimiti*’ (counter-limits) doctrine.\(^{235}\) In *Frontini (Italy)*,\(^{236}\)

\(^{232}\) ‘[T]he Union Treaty as a matter of principle distinguishes between the exercise of a sovereign power conferred for limited purposes and the amending of the Treaty, so that its interpretation may not have effects that are equivalent to an extension of the Treaty. Such an interpretation of enabling rules would not produce any binding effects for Germany.’ *Brunner (Germany)* [49]. See also: *Re Lisbon (Germany)* [314], ‘The [BVerfGE] reviews whether legal instruments of the European institutions and bodies remain within the limits of the sovereign powers conferred on them or if the Community courts interpret the treaties expansively tantamount to an inadmissible authonomous treaty amendment.’ See further: *Re Honeywell (BVerfGE)* [32], [48]-[51]; *Aid Measures for Greece (Germany)*; *Re ESM I (Germany)* [193]; *Re ESM II (Germany)* [160]; *Gauweiler I (Germany)* [20]-[21], [26], [60]; *Gauweiler III (Germany).*

\(^{233}\) *Re Lisbon (Germany)* [214] [217]-[240], ‘The ultra vires review as well as the identity review may result in Community law or, in future, Union law being declared inapplicable in Germany. To preserve the viability of the legal order of the Community… the ultra vires review as well as the finding of a violation of constitutional identity is incumbent on the Federal Constitutional Court alone.’ On the German constitutional identity jurisdiction, see Section 1.3.1.1.

\(^{234}\) *Re Lisbon (Germany)* [214].

\(^{235}\) If a Treaty or act of EU law is found to exceed the *controlimiti* of the constitutional empowerment, it ceases to produce effects in the Italian legal order. *Talamucci (Italy)*, 393. See also: *Frontini (Italy)* [3]; *Granital (Italy)*, 647; *Fragd v Amministrazione Delle Finanze Dello Stato (Italy)* Case No 232/1989 (21 April 1989) [1990] 93 ILR 538 (*Corte costituzionale*), 657; *President of Council of Ministers v Sardinian Region (Sardinian Taxes)* Judgment No 102/2008 (13 April 2008) <www.cortecostituzionaleit> accessed 18 May 2016 (*Corte costituzionale*) [8.2.8.1]. There is no procedural bases for *ex-ante* review of proposed Treaties in Italy: *Claes* (2006), 500-503, 620-624.

\(^{236}\) ‘[Art 11] legitimises those limitations of the powers of the state… on the basis of a precise criterion of jurisdiction by subject matter…’ *Frontini (Italy)* [7].
Granital (Italy),\textsuperscript{237} and Talamucci (Italy),\textsuperscript{238} the court held that the EU law is not autonomous: the constitutional authorisation for the application of supremacy does not derive from EU law, but is ‘founded upon … Article 11(2) of the Constitution.’\textsuperscript{239} It is only ‘within those areas in which the organs of the Community are competent’ that ‘the Community rule takes precedence’ over any rule of national law.\textsuperscript{240}

In France, the Conseil Constitutionnel exercises a priori control over expansions of EU law through Treaties and acts of accession,\textsuperscript{241} and the Conseil d’État\textsuperscript{242} and Cour de Cassation\textsuperscript{243} exercise a posteriori control of EU acts in excess of the act of conferral. In Re Maastricht I (France),\textsuperscript{244} Re Amsterdam (France),\textsuperscript{245} Re Constitution for Europe (France),\textsuperscript{246} Société de l’information (France),\textsuperscript{247} Re Lisbon (France),\textsuperscript{248} and La Citoyenneté (France),\textsuperscript{249} the Conseil Constitutionnel emphasised that EU law cannot run counter to a provision of the Constitution, unless the constituting power consents thereto.\textsuperscript{250} A conflict between EU law and the constitution implies that EU law is being exercised ultra vires. Where this occurs, it is for the French courts to resolve the conflict.\textsuperscript{251}

In Belgium, the Cour d’arbitrage and Conseil d’État exercise a posteriori constitutional control of Treaties and acts of accession, including expansive interpretations of EU law.\textsuperscript{252} There is no basis for

\textsuperscript{237} Granital (Italy), 649 See also: Sardinian Taxes (Italy) [8.2.8.1].
\textsuperscript{238} The application of supremacy is ‘founded upon … Article 11(2) of the Constitution.’ Talamucci (Italy), 391.
\textsuperscript{239} Frontini (Italy) [7], [11]-[12], [21].
\textsuperscript{240} Frontini (Italy) [8].
\textsuperscript{241} Re Maastricht I (France) [34]; Constitution for Europe (France) [24], (‘[C]lauses of the Treaty which transfer to the [EU] powers affecting the essential conditions for the exercise of national sovereignty in areas or on terms other than those provided for in the Treaties referred to in article 88-2 require a revision of the constitution…’); Re Lisbon (France) [9], [16], [19]; Société de l’information (France) Decision No 2006-540 DC (27 July 2006) (Conseil Constitutionnel) [9].
\textsuperscript{242} Nicolo (France) [1989] RTDE 771 (original French); available in English at: John Bell (tr), Texas Law <https://lawutexasedu/transnational/foreign-law-translations> accessed 2 July 2015 (Conseil d’État); Re Elections to the EP (France); Minister of the Interior v Cohn-Bendit (France) [1979] RGDP 832 (French); [1980] 1 CMLR 543 (Conseil d’État) (refusing to accept the direct effect of a directive); Surran, Levacher et autres (France) [1998] RFDA 1081 (original French), English version available at: <wwwlegifrancegouvfr> (Conseil d’État).
\textsuperscript{244} Re Maastricht I (France) [14], [27], [45], [50].
\textsuperscript{245} Re Amsterdam (France) [7], [27], [31]-[33].
\textsuperscript{246} Constitution for Europe (France) [7].
\textsuperscript{247} Société de l’information (France) [19].
\textsuperscript{248} Re Lisbon (France) [9].
\textsuperscript{249} Loi sur l’intégration (France) [44]-[45].
\textsuperscript{250} ‘The clauses of the Treaty which transfer to the European Union powers affecting the essential conditions of the exercise of national sovereignty in areas or on terms other than those provided for in the Treaties referred to in article 88-2 require a revision of the Constitution.’ Constitution for Europe (France) [24].
\textsuperscript{251} It is only on this condition that the Treaties are not in conflict with the constitution: Constitution for Europe (France) [12]-[13]. Preshova (2012), 280.
\textsuperscript{252} European Schools (Belgium) [B.4] ‘No rule of international law – which is a creation of the states … does give states the power to take actions against their Constitution.’ See also: Case No 62.922 Orfinger v Belgian State (Minister for Civil Service) [1997] Journal des Tribunaux 254 (5 November 1996) as translated in: Oppenheimer, The Cases (Vol II) 162 (Conseil d’État), 188. There is no procedure for preventative constitutional review in Belgium:Claes (2006), 490.
the application of EU law outside of the national constitutional empowerment, and Article 34 of the Belgian Constitution does not confer a Kompetenz-kompetenz.253

In Denmark, Sweden, and the U.K., there is no basis for the effect or application of EU law other than the national act of accession. The Högsta Domstolen (Swedish Supreme Court) derives its mandate for the doctrines of direct effect,254 indirect effect255 and the ordinary supremacy of EU law256 from Ch.5§10 of the Instrument of Government, and retains an a posteriori jurisdiction to invalidate ultra vires EU law in excess of the statutory will.257 Similarly, in Carlsen (Denmark) the Højesteret (Danish Supreme Court) interpreted Section 20 of the Constitutional Act of Denmark as prohibiting the transfer of the Kompetenz-kompetenz: An open-ended conferral, or the assumption of powers not specified in the Act of Accession (including by judicial interpretation) would violate Section 20 of the constitution.258 For this, the Højesteret retains a powerful ultra vires review jurisdiction: ‘it is for the Danish courts to decide whether EU acts exceed the limits for the surrender of sovereignty which has taken place by the Accession Act.’259 For its part, the UK House of Lords (now Supreme Court) has long held:

253 Orfinger (Belgium), 165; ‘Article 34 provides a constitutional basis for the institutional mechanisms established by the Treaty, which were intended in particular to ensure its uniform interpretation in all the Member States... Nevertheless this provision determines neither those competences which may be transferred nor their limits.’ See also: Le Ski (Belgian Cour de Cassation), 261. Art 34, Constituton of the Kingdom of Belgium (Belgian House of Representatives, 2007), reads: ‘The exercising of specific powers can be assigned by a treaty or by a law to institutions of public international law.’


257 The scope and effect of EU law in Sweden is determined by the Act concerning the accession of Sweden to the European Union (Svensk Författningssamling) 1994 No 1500. See: Konstitutionssutskottet (Swedish Committee on the Constitution), Constitutional amendments before swedish membership of the European Union (Konstitutionssutskottet report 1993/94 KU21), 22, 27. The Högsta Domstolen has defended constitutional reserves by, for example, treating conflicts with EU law as issues of purely national law and refusing to submit a preliminary reference, even though this would appear prima facie contrary to EU law: AA v Strix Television and others (Sweden) (Case No 33134/00) judgment of 5 June 2002; NJA 2002 314 available at: <https://lagennu/dom/nja/2002s314> accessed 4 July 2016 (Högsta domstolen)

258 Carlsen (Denmark) [33]. Under Section 20 of The Constitutional Act of Denmark (Folketinget, 2011) english version available at: <http://www.thedanishparliament.dk> accessed 6 June 2015, EU law may only be given effect ‘to an extent specified by statute.’ See also: Hausgaard (Denmark) [32], ‘the [EU] is still an organisation consisting of independent, mutually obliged States functioning based on powers delegated by each Member State.’ There is no ordinary ex ante mechanism for control of proposed legal acts. Challenges to the Danish Act of accession were dismissed for lack of interest in: Granborg v Prime Minister [1972] CMLR 879 (Højesteret); Tegen v The Prime Minister [1973] CMLR 1 Østre Landsret (Danish Eastern Court of Appeal) and Aggergren v The Queen and the Prime Minister [1973] CMLR 5 Østre Landsret. On Denmark, see: Koch (2001); Schermers and Waebroek (2001), 174-191; Hoegh (1999); Lebeck (2010); Grabenwarter (2011) 95-116; Krunke (2014)

259 Hausgaard (Denmark) [41]. See: Krunke (2014), 560: The Danish courts will act as guardians to ensure that the EU institutions interpret the Lisbon Treaty within the limits of the powers delegated to them by Denmark.’
‘there are no circumstances in which the jurisprudence of the [ECJ] can elevate [Union] law to a status within the corpus of English domestic law to which it could not aspire by any route of English law itself.’

**Finland** does not have a constitutional court, but *ultra vires* expansions of EU law beyond the act of accession are policed *a priori* by the Constitutional Committee of Parliament, which holds that neither the Act of Accession nor Article 95 of the Constitution allow for an EU *Kompetenz-kompetenz*.

In **Portugal**, the *Tribunal Constitucional* exercises an *a posteriori ultra vires* review jurisdiction over national implementing acts of EU law. In *Cadima (Portugal)*, the first application of supremacy, the Coimbra Court of Appeal held that EU law applied over prior national law only on the basis of Article 8(4) of the Portuese Constitution, and there could be no application of supremacy outside the scope of the act of accession. This was confirmed in *ERDF (Portugal)*, where the court subjected EEC Regulation 1787/84 on the European Regional Development Fund to *ultra vires* review.

In **Spain**, the *Tribunal Constitucional* distinguishes between the *primacia* of EU law (allowing EU law to supersede conflicting national law), and the *supremacia* of the national constitution (which both determines the status of EU law in the national order subject to integral constitutional guarantees). In *Maastricht (Spain)*, *Canary Islands Customs (Spain)*, and *Re Electoral Law*

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260 *Thoburn v Sunderland CC (UK)* [69], per Laws LJ. The Court has sometimes taken great pains to interpret EU law in line with UK statute law (rather than the other way around - see, e.g., *R (EM (Eritrea)) v Secretary of State for the Home Department (UK)* [2014] UKSC 12; [2014] 2 WLR 409 (interpreting the Charter in conformity with the Human Rights Act 1998, rather than the other way around). See also: Paul Craig, ‘Constitutional Doctrine within the United Kingdom: the Impact of the EC’ in JHH Weiler, Anne-Marke Slaughter and Alec Stone Sweet (eds), *The European Courts and National Courts: Doctrine and Jurisprudence* (Hart Publishing 1998) 195, 207, noting that the *Kompetenz-kompetenz* issue is of a different character in the UK. It is for the UK Parliament to determine the ambit of EU competence vis-à-vis the United Kingdom, and ‘the latest expression of [its] will’ is likely to be controlling.

261 This was confirmed in *ERM (Finland)*, where the Constitutional Committee found that participation in the ERM was *ultra vires* the Act of Accession even though it was established at the time of accession: *Opinion on the ERM (Finland)* (PeVL 3/1996 vp) available at: <www.eduskuntafi> accessed 1 June 2016 Perustuslakivaliokunnan (Constitution Committee) As a dualist country, all constitutional acts must be given force through ratification of the Act of Accession. For a survey, see: Stefan Griller, ‘Introduction to the Problems in the Austrian, the Finnish and the Swedish Constitutional Order’ in Alfred E Kellermann, Jaap W de Zwaan and Jenó Czuczai (eds), *EU Enlargement: The Constitutional Impact at EU and National Level* (TMC Asser Press 2001) 147, 166-167.

262 In Portugal, as a matter of pure constitutional law, the constitutional authorisation for the supremacy of EU law is provided for under Articles 7(6) and 8(4) of the Portuguese Constitution, *Cadima (Portugal)*, 679-680.

263 *It is certain that, by virtue of the principle of the precedence of the [constitutional] law (the primacy of the law or the vertical reservation of the law) enshrined in Article 115(6) -(7) of the Portuguese Constitution, there can be no exercise of the regulatory power without some basis in a lex anterior. The EEC Regulation on the ERDF is not a “law” emanating from one of the organs to which the Constitution attributes legislative competence.’ *ERDF (Portugal)*, 687-688

264 In Spain the constitutional authorisation for the application of EU law derives from the authorisation to transfer ‘powers derived from the Constitution’ by an organic act under Section 93 of The Spanish Constitution of 1978 (*Agencia Estatal Boletín Oficial del Estado*, 2015). See: *Maastricht (Spain)* [3c], [4] (‘In order for this limitation [of sovereignty] to operate, however, it is indispensable for there to be a grant of the exercise of powers.’).

265 *Maastricht (Spain)* [3c], [4]. See also: *Electoral Law (Spain)* [4].

266 *Canary Islands Customs (Spain)*, 697.
(Spain) the court held that EU primacy ‘constitutes an application of the Constitutional itself … an unequivocal act of sovereignty of Spain’ confined to the national constitutional empowerment. In Constitutional Treaty (Spain) the court held: ‘the primacy set forth for the Treaty and its resulting legislation … is reduced expressly to the exercise of the competences attributed to the European Union… by the sovereign will of the State.’

In Greece, the supremacy of EU law arises on the constitutional authority of Article 28(1) of the Constitution, within the scope of the Act of Accession/Ratification. In Karella v Minister of Industry (Greece), the Council of State stated explicitly that the EU’s powers are constrained by the Act of Accession, and that the Act of Accession is constrained by the constitution.

In Ireland, the constitutional authorisation for supremacy derives from Article 29.4.6 of the Irish Constitution, within the scope of the European Communities Act 1972 (an ordinary statute). There is no basis for the application of EU law outside the scope of the act of accession, and Article 29.4.6 does not allow for unlimited dispositions of competence by the Oireachtas. Nor does it allow EU law to introduce itself into the Irish legal order autonomously. In Crotty (Ireland), the court ruled that Article [29.4.6] allowed Ireland to participate in future amendments provided that they did not alter the essential scope or objectives of the Union.

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269 Constitutional Treaty (Spain) [3].
270 28(2) allows Parliament to ‘vest authorities provided by the Constitution’ in international organisations, and 28(1) establishes the supremacy of treaties over ordinary law. As Article 28(1) was drafted in 1975, long after the absolute conception of EU law had been introduced by the CJEU, this provision is sometimes read as an explicit constitutional rejection of absolute supremacy, since the provision did not grant primacy over the constitution. Grabenwarter (2011), 91.
271 Karella v Minister of Industry (Greece) (Case No 3312/1989) in Oppenheimer, The Cases (Vol I) 584 Συμβολά της Επικρατείας (Council of State), 586. See also: Banana Market (Greece), 578; Mineral Rights Discrimination (Greece); Real Property Acquisition (Greece) (Case No 43/1990) in Oppenheimer, The Cases (Vol I) 589 (Council of State), 589.
274 It is only through this ‘conduit pipe’ that EU law becomes part of Irish law: Tate v Minister for Social Welfare [1995] 1 IR 418; [1995] 1 CMLR 825 (High Court of Ireland), 437 per Carroll J. See also: SPUC v Grogan I (Irish Supreme Court), 765 per Finlay CJ and 770 per Walsh J; Pigs & Bacon Commission v McCarren & Co Ltd [1978] JISEL 77; [1981] IR 451, per Costello J. For comment: W Phelan, 'Can Ireland legislate contrary to European Community law?' (2008), 537: ‘the domestic law basis for the operation of [Union] law in Ireland is Irish law, here Irish constitutional law, as interpreted by the Irish courts, and not by the EUC.’
276 Crotty (Ireland), 600-601, 611-612, 619-620.
The position is similar in Estonia, and Austria, where EU law takes effect by derogation from the Constitution, but further dispositions require a constitutional referendum (Estonia)\(^{277}\) or the ‘total revision’ (Gesamtänderung) of the constitution (Austria).\(^{278}\) In Interpretation of the Constitution (Estonia), the Riijikohus held that the EU is only supreme ‘within the spheres which are within the exclusive competence of the European Union.’\(^{279}\) In ESM (Estonia), the court set out its own ultra vires review jurisdiction, declaring that ‘the [CEAA] does not authorise … the competence of Estonia to be delegated to the [EU] to an unlimited extent.’\(^{280}\) In Austria, the constitutional empowerment for the supremacy of EU law,\(^{281}\) including over constitutional law,\(^{282}\) is the Gesamtänderung procedure (Article 44(3)), which derogates from the constitution within the scope of the Federal Constitutional Act of Accession.\(^{283}\) However, it does not imbue the EU with Kompetenz-kompetenz,\(^{284}\) and it cannot be used to extend the EU’s competences without a further Gesamtänderung procedure.\(^{285}\)

The Czech Ústavní Soud (Constitutional Court)\(^{286}\) and the Polish Trybunals Konstytucyjny (Constitutional Tribunal)\(^{287}\) have both asserted an ultra vires review jurisdiction to decide whether the EU has stepped over the boundaries given to it, as well as an ‘untouchable material core’ imposing ultimate limits on the expansion of EU law. In Sugar Quotas III, the Ústavní Soud held that the transfer of sovereign powers to the EU ‘has taken place on the basis of Article 10a of the Constitution’,\(^{288}\) and it retains for itself the ability to determine ‘whether an act of the Union has exceeded the limits [of powers] which the Czech Republic transferred to the EU under Art 10a of the

\(^{277}\) EU law takes effect by derogation from the Constitution, but further dispositions will require a constitutional referendum: ESM (Estonia) [222]. The constitutional basis for supremacy is now §2 of the Constitution of the Republic of Estonia Amendment Act (CEAA), which states that the Constitution is to be applied ‘without prejudice to the rights and obligations arising from the Accession Treaty.’ See: Hofmeister (2007), 70.

\(^{278}\) A total revision requires not only a two-thirds majority in Parliament (the ordinary revision procedure), but also a positive vote in a referendum: Austrian Federal Constitution (Bundeskanzleramt) english version available at: https://www.ris.bka.gv.at> accessed 6 June 2015, art 44(3).

\(^{279}\) Interpretation of the Constitution (Estonia) [15]-[16].

\(^{280}\) ESM (Estonia) [222]. ‘Therefore, it is primarily the Riijikohus which must, upon a change in any amending treaty … decide whether the amendment … leads to a deeper integration process of the [EU] and thereby an additional delegation of competence.’

\(^{281}\) Natural Mineral Water (Austria) (Case No QZ V 136/94) judgment of 12 December 1995 in Oppenheimer, The Cases (Vol I) 133 (VGH); Tyrolian Provincial Allocation Office (Case No GZ B 2477/05) judgment of 12 June 1996 in Oppenheimer, The Cases (Vol I) 135 (VGH); Tourism Promotion Tax (Austria) (Case No G 2/97) judgment of 24 Jun2 1998 in Oppenheimer, The Cases (Vol I) 137 (VGH), at 142.

\(^{282}\) Telecom Control Commission (Austria) (Case No B 1625/98) judgment of 24 February 1999 (VGH).


\(^{284}\) In ESM (Austria) the court held that dispositions under the Constitution must be ’specific and limited.’

\(^{285}\) The result of this is that the act ‘does not cover later amendments of the EU legal order, especially those agreed during intergovernmental conferences.’ Griller (2001), 149. The position of the Austrian Government prior to accession was that, ‘the fixed core of Austrian constitutional law cannot be changed by Community law nor indeed be required to be interpreted in the light of [EU] law.’ See: Foster, Austrian Legal System & Laws (2003), 144.

\(^{286}\) Sugar Quotas III (Czech Republic) PI US 50/04 (8 March 2006) [2006] 3 CMLR 15 (Ústavní Soud) [A-3B]; Lisbon I (Czech Republic) [139]; Treaty of Lisbon II (Czech Republic) PI US 29/09 (3 November 2009) (Ústavní Soud) [136], [150]

\(^{287}\) Accession Treaty (Poland), grounds 1, 8, 12-13, 18; EAW (Poland), ground 9; Lisbon (Poland), grounds 2.2 et seq; Brussels Regulation (Poland), grounds 1.5, 2.2 et seq.; ESM & TSCG (Poland), ground 3.2 et seq

\(^{288}\) Sugar Quotas III (Czech Republic) [106].
Constitution.\textsuperscript{289} Similarly, in Lisbon (Poland) the Trybunai Konstytucyjni held: ‘The protection of state sovereignty… requires respecting the constitutional limits of conferral of competences … the deciding powers [of which] are vested in the relevant authorities of the Republic of Poland.’\textsuperscript{290}

In Latvia, the Satversmes tiesa (Constitutional Court) is empowered to review the constitutionality of EU law both \textit{a priori} ratification and \textit{a posteriori}, and the court explicitly denies an EU \textit{Kompetenz-kompetenz}.\textsuperscript{291}

In Lithuania, the Konstitucinis Teismas (Constitutional Court) has declared the supremacy of all constitutional provisions - not just fundamental guarantees, and exercises an \textit{ultra vires} jurisdiction over the treaties and all implementing acts of EU law.\textsuperscript{292}

In Malta, the act of accession is subject to the Constitution, and expansions of EU law in violation of the constitutional constraints on empowerment may be reviewed for unconstitutionality.\textsuperscript{293}

\textsuperscript{289} Lisbon I (Czech Republic) [139] (holding the conferral of an open-ended \textit{Kompetenz-kompetenz} would violate the principle of democracy). See also: Lisbon II (Czech Republic) [136], [150], [170]. The \textit{Ústavní Soud} has, in fact, invalidated an ECJ decision as \textit{ultra vires}: Slovak Pensions XVII (Czech Republic) PL US 5/012 (31 January 2012) English version available at: <http://wwwusoude/> accessed 28 May 2016 (\textit{Ústavní Soud}).

\textsuperscript{290} Lisbon (Poland), grounds 2.2 et seq.

\textsuperscript{291} Re Lisbon (Latvia), 53 (the EU cannot extend its own competences), 57 (competences conferred on the union must be limited and ‘defined clearly’). Constitutional complaints have largely been in the form of \textit{ex ante} challenges to accession, or ratification of the EU treaties: \textit{Marine Convention (Latvia) 10; Blank Tape Levy (Latvia); Riga Land Use Plan (Latvia).} See: Tatjana Evas, Judicial Application of European Union Law in post-Communist Countries: The Cases of Estonia and Latvia (Routledge 2016), 40; Anita Ušacka, ‘The Impact of the European Integration Process on the Constitution of Latvia’ in Alfred E Kellermann, Jaap W de Zwaan and Jenő Czuczai (eds), \textit{EU Enlargement: The Constitutional Impact at EU and National Level} (TMC Asser Press 2001) 337; Kristine Kruma, ‘Constitutional courts and the Lisbon Treaty: The future must be based on mutual trust’ in Elspeth Guild and Sergio Carrera (eds), \textit{The Area of Freedom, Security and Justice ten years on: successes and future challenges under the Stockholm Programme} (CEPS 2010); Albi, ‘Supremacy of EC law in the new member states’ (2007); Mayer (2009), 419; Evas, \textit{The Cases of Estonia and Latvia} (2016), 31-79, 181-204; Ringold Balodis and Janis Pleps, ‘Financial Crisis and the Constitution in Latvia’ in Xenophon Contiades (ed), \textit{Constitutions in the Global Financial Crisis} (Ashgate Publishing 2013) 115; Hoffmeister (2007), 84


\textsuperscript{293} In Malta, the constitutional authorisation for the application of EU law derives from Article 65 of the Constitution of Malta (Ministry for Justice, Culture and Local Government of Malta, 2014), as amended by the European Union Act (Malta). That article allows the Parliament to make laws in full conformity with respect for human rights, international law, and obligations of EU law, and therefore provides for the (ordinary) supremacy of EU law over statutes. However, an amendment to the constitutional supremacy clause of Article 6 could not be achieved, and EU law is not supreme over the constitution. See: Peter G Xuereb, ‘Constitutional Questions Raised by the Proposed Accession of Malta to the European Union in the General Context’ in Alfred E Kellermann, Jaap W de Zwaan and Jenő Czuczai (eds), \textit{EU Enlargement: The Constitutional Impact at EU and National Level} (TMC Asser Press 2001) 229; Anneli Albi, ‘Supremacy of EC law in the new member states.’ (2007) 3 EuConst 35; Mayer (2009), 419; Tanja Karakamisheva-Jovanovska, ‘European Union Member-States and Changes in their National Constitutions - Lessons for Macedonia’
In **Slovakia**, EU law can have no force of other than that provided by the act of accession, and the **Ústavný súd** (Constitutional Court) has both an *a priori* and *a posteriori* jurisdiction to control the constitutionality of treaties. The position is the same in **Bulgaria**, where the court reviews the constitutionality of treaties; and in **Romania**, where the *Curtea Constituțională* has engaged in *a posteriori* constitutionality reviews of national implementing acts of EU law.

In **Hungary**, **Slovenia** and **Cyprus**, EU law is given an equivalent (but not superior) rank to the constitution and the **Magyarország Alkotmánybírósága** (Constitutional Court of Hungary), **Ustavno Sodišče** (Slovenian Constitutional Court), and the Cypriot Supreme Court, have all reviewed EU law against the limits of the constitutional empowerment.

Only two Member States, **Luxembourg** and the **Netherlands**, accept the absolute normative justification for supremacy as enunciated by the ECJ, but neither do so on the basis of European constitutionalism. In practice, the Dutch and Luxembourg courts tend to accept the supremacy of EU law without pronouncing on whether this authority stems from the Constitution itself or directly

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294 Art 84(4) of the Slovak Constitution.

295 Constitution of the Slovak Republic (Verejny Ochrana Práv, 2016), art 125(1)(a) reads: ‘Laws with the Constitution, constitutional laws and international treaties to which the National Council of the Slovak Republic has expressed its assent and which were ratified and promulgated in the manner laid down by a law.’ See: Kunová (2001); Klučka (2005); Slastan (2006), 437, 444-445; Hoffmeister (2007) 85-86.


299 The application of EU law is derived only from Art 3a of the Constitution, by which principles of EU law become ‘internal constitutional principles.’ See Slovene National Holding Company Act (SNHCA) (Case U-II-1/12, U-II-2/12) of 17 December 2012 (English version) (Ustavno Sodišče) [3]-[6], [20]-[22], [51]-[54].

300 European Arrest Warrant (Cyprus) Civil Appeal no 294/2005 (Judgment of 7 November 2005) (Supreme Court).

301 In the Netherlands even unconstitutional treaties can be ratified by the Houses of the States (Article 91(3) of the constitution) and national courts are prohibited from reviewing international treaties (Article 120): Constitution of the Kingdom of the Netherlands (Ministry of the Interior and Kingdom Relations, 2008). In Luxembourg, national courts are prohibited from reviewing the constitutionality of Treaties by Article 95 of the Luxembourg Constitution, and the *Cour de Cassation* has held since *Pagani (Lux)* in 1954 that an international treaty should prevail over national law: ‘Where there is a conflict between the provisions of an international treaty and the provisions of a subsequently enacted municipal law, international law must prevail over national law.’ See: Kaczorowska (2013), 256; Claes, *National Courts' Mandate* (2006), 532 (noting that the Netherlands itself owes its existence to the 1815 Vienna Peace Treaty).
from the Treaty.  This doctrinal lacuna has led a persistent strand of Dutch scholarship to argue that EU law would apply even if the constitutional bases for conferral were abolished: - idem est, ‘the Dutch constitution is entirely irrelevant in that regard.’  However, this would seem to be overstated. In both countries, the supremacy of EU law remains a creature of the national constitutional empowerment. The 1960’s case law of the Dutch Raad van State clearly located the constitutional authority to disapply national law in the Dutch Constitution – not international law - and there is nothing to have altered this position. In Bosch (NV) and Metten (NV), both the Hoge Raad and Raad van Sate took the instruction to disapply national law from the Constitution – not EU law. The same is true in Luxembourg, where the amendment procedure of Article 114 of the Luxembourg Constitution was necessary to ensure the constitutionality of the Maastricht Treaty. Moreover, expansions of EU law cannot be given effect unless ratified by super-majority in under Article 91(3) of the Dutch Constitution, or Article 114 of the Luxembourg Constitution.

In summary, under all of these jurisdictions, an instrument of secondary EU law which has not been conferred in accordance with the constitution is, in principle, inapplicable in the national legal order without (at minimum) parliamentary ratification or treaty amendment.

These ultra vires review jurisdictions are based on intuitive logic: As reflected in Articles 4(1), 5(1) and 5(2) TEU, what is ultra vires EU law is a function of national constitutional law. These means that - supreme and legitimate within its bounds though it may be - there are nonetheless boundaries of the Union legal order beyond which the states are sovereign, and Member State constitutional law is the reference point for what those boundaries are. The BVerfGE states:

The “Constitution of Europe”, international treaty law or primary law, remains a derived fundamental order … [it] is always limited factually. […] European integration continues to

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303 For a summary, see: Monica Claes and de Witte (1998), 183, ‘There are in fact, two schools of thought on the question of the ultimate ground for the domestic effect of Community law: doe it rest upon the constitutional articles presented above, or does it rather rest purely and exclusively on its autonomous character as defined by the European Court?’
304 It would be difficult to find in these provisions a justification for the absolute primacy asserted by the CJEU in International Handelsgesellschaft, since they are, in themselves, constitutional provisions. For this point: De Witte, ‘The Nature of the Legal Order’ (2011), 355. Monica Claes and de Witte (1998), 185 also point out that the constitutional supremacy view was confirmed by the views of Government and Parliament during the constitutional amendment of 1983.See also: Grousso (2008), 99, “the supremacy of [EC] law is accepted because it has been given effect by national constitutional modalities.”
306 Bosch (Netherlands); Metten (Netherlands).
308 For this reason, Monica Claes and de Witte (1998) at 188 argue that the Kompetenz-kompetenz is possessed by the Government and Parliament, and that an ultra vires claim is, in principle, possible where the ultra vires act is not ratified.
309 Grimm (1995), 287, 288: even if one accepts that national powers transferred to the EU are no longer subject to national law, it remains that ‘national constitutions regulate the conditions on which the Member States may transfer sovereign rights’ in the first place.
take place according to the principle of conferral without the possibility for the European Union of taking possession of Kompetenz-Kompetenz or to violate the Member States’ constitutional identity, which is not open to integration. […] [T]he Treaty of Lisbon does not vest the European union with provisions that provide the [EU] of integration (Integrationsverband) with the competence to decide on its own competence (Kompetenz-Kompetenz).”

It would be an odd result indeed if the Union were the final arbiter of what had been conferred under Member State constitutions. It would be up to the Union to decide the limits of its own power, and there could be nothing to say otherwise. As the Tribunal Constitucional has emphasised:

‘the competences whose exercise is transferred to the [EU] could not, without a breakdown of the Treaty itself, act as a foundation for the production of Community regulations whose content was contrary to the values, principles or fundamental rights of our Constitution … Therefore, the primacy operates with regard to the competences transferred to the Union by the sovereign will of the State and also sovereignty recoverable by means of the “voluntary withdrawal.”

For the purposes of this thesis, the limits of EU competence under Member State ultra vires review jurisdictions provide a valid description of the constitutional limits of EU law in national legal orders.

1.2.1.2 Normative Evaluation of Member State Ultra Vires Review

When the Union acquires its competences upon ratification by the Member States ‘in accordance with their respective constitutional requirements’ under Articles 48(4) TEU, 49 TEU, 54 TEU and 357 TFEU, the supremacy of EU law is secured within the constitutional order because conferral cannot be done in such a way that it would violate or vitiate the constitution. As Tribunal Constitucional so puts it, ‘public authorities are no less subject to the Constitution when they act in the international or supranational relations than when they exercise their competences ad intra.”

‘Absolute’ supremacy, however, again implies something different. It implies a normative claim: That the ‘effectiveness and uniformity of EU law’ is of such priority that it will always outweigh any conflicting constitutional values in a conflict of norms, even those which constrain the act of ratification. Take, for example, the apocryphal statement of EU supremacy by Pernice:

310 Re Lisbon (Germany) [207], [215], [298] (emphasis added
311 See, e.g. Brunner (Germany) [67], ‘If [the Treaty] were a basis for a power to take powers, it would cut across the whole system of competences under the Union Treaty, as well as [the Treaties themselves] and make them largely meaningless.’
312 Constitutional Treaty (Spain) [3].
313 Maastricht (Spain), [1].
314 Supremacy means that even ‘the most minor piece of technical [Union] legislation ranks above the most cherished constitutional norm.” Weatherill (1995), 106. As stated in Costa v ENEL ‘the executive force of Community law cannot
‘a residual control of the Court of Justice by national Constitutional courts in cases of continuous and evident violations of fundamental rights or [ultra vires acts] as an element of balance of powers is excluded, since … non-application of Community law in one Member State would jeopardize the status of legal equality of the Union citizens which is the foundation of its functioning.’

In that regard, it suffices here to state that this normative claim is not accepted in any of the Member State authorities catalogued in this thesis. The principle here is that the Member States cannot hold the “effectiveness and uniformity” of EU law above the constitution, because powers conferred under the Union are subject to the constitution. Supremacy only applies intra vires EU law; ultra vires review only describes what is outside EU law (and what is outside EU law is determined by national constitutional law). As national constitutional courts have been keen to assert, the uniformity and effectiveness of EU law within its competences cannot depend on the appropriation of national powers outside them. On this basis, Member States evince three approaches to reconciling the ordinary supremacy of EU law with national constitutional law:

In a first group of countries, consisting of France, Denmark, Greece, Spain, the Czech Republic, Poland, Slovenia, Slovakia, Romania, Belgium, Bulgaria, Latvia,

vary from one Member State to another in deference to subsequent domestic laws, without jeopardising the attainment of the objectives of the Treaty’. For other expositors of these arguments, see: Pescatore (1970); Pernice, ‘Multilevel Constitutionalism’ (1999); Schiemann (2007) (arguing, essentially, that the nation-state is evil in and of itself). Christiaan Timmermans, ‘Publication Review: The Worlds of European Constitutionalism’ (2014) 10 EuConst 349, 352 (viewing such a challenge as a challenge to ‘the absolute nature of primacy of Union law’). Kumm, ‘Final Arbitre’ (1999), 370 identifies three arguments against democratic statism: (1) The nation state is ‘an evil in and of itself’; (2) national law ‘undermines the expansion of the liberal Rule of Law’; and (3) national democracy is obsolete in an international world of spillovers.

Pernice, ‘Multilevel Constitutionalism’ (1999), 727; For a more robust explanation of this rationale, see: Kumm, ‘Final Arbitre’ (1999), 355 (supremacy is necessary to prevent clashes of interests and the protection of fundamental rights and democracy within national states).

‘None of the constitutional courts has accepted the unconditional supremacy of Community law.’ Claes, National Courts’ Mandate (2006), 261. See also: Kaczorowska (2013), 239; Preshova (2012), 280; De Witte, ‘The Nature of the Legal Order’ (2011), 352; Dyevre (2013) 147; Mayer (2009).

EU supremacy and national ultra vires review are, by definition, mutually exclusive. See, e.g., Spain: Constitutional Treaty (Spain) [4] (‘supremacia [of the constitution] and primacia [of EU law] are categories which are developed in differentiated orders … primacia is not necessarily based on hierarchy, but on the distinction between the scopes of application of different norms… The supremacy of the Constitution is therefore compatible with application systems which confer priority to the application of norms of other legal systems insofar as the Constitution provides for it.’). Germany: Re Lisbon (Germany) [308], [311]; Re Honeywell (BVerfGE) [38]; EAW (2735/14) (Germany) [I.1]. Poland: Accession Treaty (Poland), ground 17; Lisbon (Poland), grounds 2.1, 2.2 et seq. France: Re Lisbon (France) [8] (‘confirming the place of the Constitution at the summit of the domestic legal order…’); Constitution for Europe (France) (noting that, because EU law is supreme only by virtue of Art 88-1 French Constitution, the duty to apply it does not apply where there is an “express contrary provision.”) Czech Republic: Sugar Quotas III (Czech Republic) at [A-3B].

See, e.g., EAW (2735/14) (Germany) [I](2)(b). See also: Stefan Theil, ‘What Red Lines, if Any, Do the Lisbon Judgments of the European Constitutional Courts draw for Future EU Integration?’ (2014) 15 German LJ 599, 610, national courts ‘are merely challenging the ‘automatic and self-fulfilling transfer of sovereign powers to the EU, removed from adequate control through the Member States.’

The application of EU law applies under Articles 55 and 88-1 of the Constitution of France. Article 55 does not provide for supremacy over the constitution, and the ‘common exercise of powers’ clause of Article 88-1 implies a nemo plus turritus rule, which prevents the exercise of powers unconstrained by the constitution: Re Lisbon (France) [7]-[9]; Société de l’information (France) [19]-[20]; Loi sur l’intégration (France) 9; Loi sur l’intégration (France): This
provision ‘confirm[s] the place of the Constitution at the pinnacle of the national legal order.’ See also Constitution for Europe (France) [24]: ‘clauses of the Treaty which transfer to the [EU] powers affecting the essential conditions for the exercise of national sovereignty … require a revision of the constitution.’ See: Richards (2006)

Section 20 of the Constitutional Act of Denmark allows for the ‘delegation of powers’ to international authorities ‘to such extent as shall be provided by statute.’ The assumption of powers not specified in the act of accession would violate the constitution: Carl sen (Denmark); Hausgaard (Denmark).

Article 28 of the Hellenic Constitution allows Parliament to ‘vest authorities provided by the Constitution’ in international organisations and ‘limit the exercise of national sovereignty.’ However, Art 28(1) of only allows for supremacy over ordinary law. Art 28(2) further states that limitations of sovereignty must ‘not infringe upon the rights of man and the foundations of democratic government.’

Section 93 of the Spanish Constitution, authorises the transfer of powers ‘derived from the Constitution’ by organic act. See: Ley Orgánica 10/1985 (2 August 1985) on Authorisation for the Accession of Spain to the European Communities. Constitutional Treaty (Spain) [2] ‘Art. 93 CE operates as a door through which the Constitution itself allows the entry of other legislations into our constitutional system through the transfer of the exercise of competences.’ Confirmed recently in Melloni (Spain) [3]. See also: Canary Islands Customs Regulation (Case No 4524/1989) 17 April 1989, in Oppenheimer, The Cases (Vol I) 694 (Tribunal Constitutional) 697.

The authorisation for the application of EU law derives from arts 1(2) and 10 of the Constitution of the Czech Republic 1993 (English available at: <https://www.constituteproject.org> accessed 9 July 2016), under which international law is granted supremacy over statutes, but not constitutional law.

Article 90 of the Polish Constitution allows the ‘delegation’ of ‘the competence of organs of State authority in relation to certain matters,’ and Article 91 provides for the direct effect and ordinary supremacy of EU law over statute. See Accession Treaty (Poland) [5]; Lisbon (Poland), ground 2.1.

Art 3 of the Constitution of Slovenia (Official Gazette of Slovenia Nos. 33/91-I, 42/97, 66/2000, 24/03, 69/04, 68/06, and 47/13) available in English at: <www.us-rs.si> accessed 10 July 2015 allows Slovenia to ‘transfer the exercise of part of its sovereign rights to international organisations which are based on respect for human rights and fundamental freedoms, democracy, and the principles of the rule of law.’ This gives EU law an equivalent (but not superior) rank to the constitution: Electronic Communications Act (Case U-I-65/13) of 26 September 2013 (Ustavno Sodišče), 7

Art 7(2) of the Constitution of the Slovak Republic (Verejny Ochrana Prav, 2016) states that EU norms ‘shall have precedence over laws of the Slovak Republic.’ Given that the Ústavný súd has jurisdiction to rule on the constitutionality of treaties (Art125(1)(a)) and unconstitutional treaties require an amendment to the Constitution (Art 84(4)), ‘laws’ in Article 7(2) does not include the constitution.

Art 1(5) of the Romanian Constitution provides for the supremacy of the Constitution over international law.

Art 34 of the Constitution of the Kingdom of Belgium (Belgian House of Representatives, 2007) states: ‘The exercising of specific powers can be assigned by a treaty or by a law to institutions of public international law.’ For interpretation see Orfinger (Belgium), 165-166. Bri bossis (1998), 11 notes that in ‘forty years, the Constituent Assembly has sought eight times to insert in the Constitution a provision providing for the primacy of treaties over constitutional statutes’, but has never been successful). See further: Schermers and Waebroek (2001) [157]-[191]; Claes, National Courts’ Mandate (2006), 199-204, 242-243, 506-513, 639-645; Mayer (2009); Grabenwarter (2011).

The authorisation for EU law derives from Arts 4(3) (participation in the EU); 85(1)(9) (the National Assembly may confer powers on the Union); and Art 5(4) of the Constitution (international treaties have primacy over of domestic legislation). However, Article 85(4) prohibits the ratification of treaties in conflict with the constitution and Art 149(1)(4) grants judicial jurisdiction over implementing acts and treaties.


Authorisation for the application of EU law derives from Art 65 of the Constitution, as amended by European Union Act (Malta) Act V of 2006 (Chapter 460) of 16 July 2003. However, an amendment to the constitutional supremacy clause of Article 6 could not be achieved, and EU law is not supreme over the constitution.

In Lithuania, EU law takes effect in national law under para 2 of the Constitutional Act ‘On Membership of the Republic of Lithuania in the European Union’ of 13 July 2004 (Lithuania), which states that EU law is supreme over EU law, but not constitutional law. See: On limitation of rights of ownership (Lithuania) [9.4].
be unconstitutional. This means that the absolute normative supremacy of EU law is not accepted over any provisions of the Constitution. A conflict between EU law and a provision of the Constitution indicates that the constitutional empowerment for EU law has been implemented ultra vires. National constitutional courts may declare the implementation of EU law invalid on that basis, or it may resolve the conflict according to their normative weight, just like any other clash between constitutional principles. This can be seen in decisions such as Maastricht (France), Lisbon (France), Maastricht (Spain), Lisbon (Latvia), ERM (Finland), or EAW (Cyprus) where the application of EU law required the clearing of normative conflicts by constitutional amendment, or Slovak Pensions XVII (Czech Republic) (where the Ústavní Soud declared an ECJ decision ultra vires) and DI.KATSA (Greece) (where the Council of State resolved a conflict with a directive in favour of the latter).

In a second group of countries, consisting of Germany, Italy, the United Kingdom, Ireland, Portugal, Austria, Sweden, Cyprus, Estonia, Finland, and Hungary, the

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333 See, e.g., Art 5 4 of the French constitution, under which the Conseil Constitutionnel review the conformity of EU treaties before they confer powers on the Union, in this way acting as a ‘gateway’ by which nothing unconstitutional can pass through to Act of Accession. See: Claudina Richards, ‘The supremacy of Community law before the French Constitutional Court’ (2006) 31 EL Rev 499, 502.

334 Claes (2006), 159
335 Re Maastricht I (France) [14]; Re Lisbon (France); Maastricht (Spain), grounds [3(a), [3(c), [4]; Re Lisbon (Latvia), at 53; Opinion on the ERM (Finland); EAW (Cyprus).
336 Slovak Pensions XVII (Czech Republic).
337 DI.KATSA (Greece).
338 Article 23(2) of the Basic Law allows the ‘delegation’ of sovereign powers, subject to the inviolable principles shielded from amendment by Article 79(3) BL (see Section 1.3.1.1).
339 Article 11 of the Italian Constitution, by which ‘Italy agrees, on conditions of equality with other States, to the limitations of sovereignty,’’ is subject to the ‘contralimiti’ doctrine: Frontini (Italy).
341 Art 29.4.6 of the Irish constitution states: ‘No provision of this Constitution invalidates laws … that are necessitated by the obligations of membership of the European Union,’ however the European Communities Act 1972 is subject to the constitution. See: Maria Cahill, 'Constitutional exclusion clauses, article 29.4.6, and the constitutional reception of European law' [2011] 34 DULJ 74.
342 Art 7(6) of the Constitution of Portugal authorises the ‘joint exercise, in cooperation or by the Union’s institutions subject to reciprocity and with respect for the fundamental principles of a democratic state based on the rule of law and… subsidiarity.’
343 EU supremacy is provided by the Federal Constitutional Law on the Accession of Austria (Federal Law Gazette 1994/744). Any further amendment of the Act of Accession basic structures requires a ‘total revision’ of Article 44(3) of the Austrian Constitution, unless it can be agreed under Art 9(2) of the Austrian Federal Constitution: ‘By law or state treaty… may be transferred specific Federal competences to other states or intergovernmental organizations.’
344 Ch 10§ of the Instrument of Government states: ‘The Rikstak may transfer a right of decision-making which does not affect the principles of the form of government within the framework of European Union cooperation. Such transfer presupposes that protection for rights and freedoms in the field of cooperation to which the transfer relates corresponds to that afforded under this Instrument of Government and the [ECHR].’
345 The Cypriot Supreme Court long denied the supremacy of treaties over the constitution. However the Fifth Amendment of the Constitution, Law 127(I) of 2006 Office of the Law Commissioner) ŘEN (A) – L.94 amended Article 1A to read: ‘No provision of the Constitution shall be deemed to annul laws enacted, acts done or measures taken by the Republic which become necessary by reason of its obligations as a member state of the European Union.’
346 Section 2 CEAA states that the Estonian Constitution is to be applied ‘without prejudice to the rights and obligations arising from the Accession Treaty.’
constitutional empowerment for the application of EU law does apply irrespective of conflicting constitutional law, either by derogation from the constitution or an extraordinary instrument that bestows heightened rank on EU law. However, in these countries, EU law does not take effect autonomously, and the derogation does not apply to some core constitutional principles which are either beyond the reach of the legislator or simply always of greater normative weight than the effectiveness of EU law. These include, for example, British parliamentary sovereignty, the Italian controlimiti doctrine, and the ‘eternity clause’ in Article 79(3) of the German Basic Law. This model can be seen at work in decisions such as UN Convention (Italy), European Schools (Belgium), Accession Amendments (Sweden), EM (Eritrea) v SSHD (UK), Brunner (Germany), Grogan (Ireland), EAW (Poland), Agricultural Stocks (Hungary), Gauweiler (Germany), and EAW 2735/14 (Germany), where constitutional courts applied integral constitutional principles over the ‘effectiveness and uniformity’ of EU law.

In a third group of countries, consisting essentially of the Netherlands and Luxembourg, EU law is supreme over all conflicting substantive provisions in the Constitution. However, an

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350 Supremacy was originally provided for by an ‘Exception Act’, which derogated from the ordinary provisions of the Constitution: Art 1540/94 of the Statutes of Finland (Act of Accession) and has been accepted on this basis since VAT Deduction Rights (Finland) of 31 December 1996 in Oppenheimer, The Cases (Vol II) 193 (Supreme Administrative Court). However, this is subject to S. 1 of the Constitution: ‘Finland is a sovereign republic…. The constitution shall guarantee the inviolability of human dignity and the freedom and rights of the individual and promote justice in society.’

351 UN Convention (Italy) Judgment No 238/2014 (22 October 2014) available at: <www.cortecostituzionale.it> accessed 22 June 2016 (Corte costituzionale) [3.2]-[3.4].

352 European Schools (Belgium) [B.4].


355 Brunner (Germany).

356 SPUC v Grogan I (Irish Supreme Court), 765, per Finlay CJ (Hederman and Griff JJ concurring): ‘In the instant case where the right sought to be protected is that of a life, there can be no question of a possible or putative right which might exist in European law as a corollary to a right to travel so as to avail of services…”

357 EAW (Poland).

358 Agricultural Surplus Stocks (Hungary) [IV.1], [IV.4].

359 Gauweiler I (Germany) and Gauweiler III (Germany) (ruling that the ECB’s OMT programme intruded on constitutional guarantees shielded by Article 79(3) BL, and placing six conditions on the operation of the programme.

360 EAW (2735/14) (Germany) [76]-[78] (rebuffing the CJEU’s Melloni decision before overturning a decision of a German Higher Regional Court, even though ‘the Higher Regional Court’s decision is determined by Union law.)

361 Articles 93 and 94 of the Dutch constitution establish the direct effect and supremacy of all international law, and even unconstitutional treaties can be ratified by the Houses of the States (Article 91(3)). Moreover, Art 120 prohibits national courts from reviewing the constitutionality of treaties. Art 92 of the Dutch Constitution: ‘Legislative, and judicial powers may be conferred on international institutions by or pursuant to a treaty, subject, where necessary, to the provisions of Art 91 paragraph 3.’ Art 91(3) states: ‘3. Any provisions of a treaty that conflict with the Constitution or
expansion of EU law beyond the scope of the act of ratification still requires democratic ratification in accordance with the Constitution. In effect, it would seem that EU law is not normatively supreme over the principle of constitutional democracy: The EU can have no powers without a vote by the Dutch or Luxembourgish people. 364

All of these jurisdictions have two features in common: First, as a matter of pure constitutional law, the sovereignty claim of European constitutionalism is rejected. No Member State accepts absolute supremacy over Kompetenz-kompetenz adjudication. 365 In all of the constitutions studied, the supremacy of EU law flows from a legislative instrument enacted under a specific constitutional window. 366 This principle - that the EU is a derived legal order circumscribed by the act of accession and subject to the limits of the constitution - is the fundamental basis of ultra vires review jurisdictions in all Member States. 367

The second feature these jurisdictions have in common is that the ‘absolute’ normative supremacy of EU law is impossible: acts of accession are themselves subject to ‘limits under constitutional law.’ 368 In Brunner (Germany), for example, the BVerfGE held that it would be impossible for the EU to discover itself to have the power to decide its own competences, because the German legislator has no power to bestow it. 369 In all countries, this principle means that a conflict between legal orders indicates that one has been implemented ultra vires, and where this occurs, the normative weight of EU supremacy can only have the weight assigned to it under constitutional law. 367 In virtually all Member States, clashes with EU law are ‘infra-constitutional’ or ‘non-constitutional’ seen by constitutional courts as clashes with the constitutional authorisation for membership of the Union, and the status of EU law in the national order is therefore ‘a fact which must be considered as

which lead to conflicts with it may be approved by the houses of the States General only if at least two-thirds of the votes cast are in favour.’ 363

Art 49 bis of the Constitution of Luxembourg of 1868 (William S Hein & Co, 2012) states: ‘The exercise of the attributions reserved by the Constitution to the legislative, executive and judicial powers may be temporarily vested by treaty in institutions of international law.’ Art 95 prohibits national courts from reviewing the constitutionality of treaties. 364


De Witte, ‘The Nature of the Legal Order’ (2011), 352 notes: ‘This does not matter too much for the relation between EU law and ordinary legislation, because all national courts found the legal resources to ensure, by and large, the supremacy of EU law in those cases.’ See also: Mayer (2009).

For similar analyses and comparisons, see: Monica Claes, 'Constitutionalizing Europe at its Source: The "European Clauses" in the National Constitutions: Evolution and Typology' (2005) 24 YEL 81; Grabenwarter (2011), 95.

For the genesis of this reasoning, see: Solange I (Germany); Wojciech Sadurski, ‘"Solange, chapter 3": Constitutional Courts in Central Europe’ (2014) 14 ELJ 1.

Solange II (Germany) [II](1)(b); Solange I (Germany) [3]. Since all EU competences are conferred under national constitutional law, nothing unconstitutional can pass through the act of accession - except possibly the Luxembourg and the Netherlands, where courts cannot review Treaties. See: Claes, National Courts’ Mandate (2006), 159.

An open-ended conferral of power on the Union to decide its own competences (the Kompetenz-kompetenz) would violate the inviolable principle of democracy (Article 20 BL) shielded by the ‘eternity clause’ (Article 79(3)) of the 1949 Constitution: Brunner (Germany).

Even in Luxembourg and the Netherlands, where treaties are not reviewable because of national constitutional law.

established from the perspective of [national] law. The simple reason for this, as explained by the BVerfGE, is that the shape of EU competences are a function of the Member State’s constitutional law, and as the ECJ cannot interpret the German constitution, ultra vires review is ‘incumbent on the German court alone.’

The ultra vires review jurisdiction of the BVerfGE is paradigmatic, and, for structural reasons explained below, the most important to this thesis. It emerged in Solange I (Germany), when the BVerfGE was faced with an EU supremacy claim that professed to apply state powers in a manner that would have been unconstitutional for the German State to have done. In that case, the BVerfGE held that EU law could not apply outside the boundaries of the constitutional empowerment because it is a derived legal order subject to the limits of the Act of Accession: ‘Internal priority of validity or application [of EU law] only arises by virtue of an application of law instruction to that effect under the national law.’ On this basis, in Brunner (Germany), the court then set out its ultra vires review jurisdiction, as follows:

‘[T]f European institutions or agencies were to treat or develop the Union Treaty in a way that was no longer covered by the Treaty in the form that is the basis for the Act of Accession, the … German state organs would be prevented for constitutional reasons from applying them in Germany. Accordingly, the [BVerfGE] will review legal instruments of European institutions and agencies to see whether they remain within the limits of the sovereign rights conferred on them or transgress them.’

According to the BVerfGE, ultra vires review merely ‘ensures that the primacy of application of Union law only applies by virtue and in the context of the constitutional empowerment that continues

372 Canary Islands Customs (Spain), 697.
373 Re Lisbon (Germany) [216]-[217]. Indeed, under Article 100 BL, Germany’s own court system works in this way - where an offending measure violates a constitution, jurisdiction is attributed to the court whose constitution it offends (Länder or Bund), not the institution which promulgated it.
374 See Section 1.3.1.1. For a comparative account of the development of German constitutional review of EU law, see: Juliane Kokott, 'Report on Germany' in JHH Weiler, Anne-Marke Slaughter and Alec Stone Sweet (eds), The European Courts and National Courts: Doctrine and Jursprudence (Hart Publishing 1998) 77.
375 Solange I (Germany) (1974) established that ‘so long as’ European law had not yet reached a level of protection of fundamental rights equivalent to the Basic Law, the court would continue to review secondary EC law. Then in Solange II (Germany) the court established that ‘so long as’ an equivalent level of protection had been reached, it would no longer exercise its review jurisdiction [II](1)(b)). In the Bananas case, the BVerfGE narrowed this even more, limiting the application of its jurisdiction to examining whether the EU institutions provided a sufficient level of protection in general: Bananas (Germany) (Case 2 BvL 1/97): BVerfGE 102, 147 (available in English at: <http://www.bverfg.de/e/is20000607_2bv1000197en.html> accessed 18 June 2014).
See also: Brunner (Germany) [37]-[38], [55]; Re Lisbon (Germany) [308], [315], [319], [385]; Re Honeywell (BVerfGE) [38]; Gauweiler I (Germany) [20]; EAW (2735/14) (Germany) [I].
377 Brunner (Germany) [40], [55], [59] [99] (with regard to expansive CJEU court rulings), and 65 (with regard to autonomous resources). See also: Re ESM I (Germany) [193]; Re ESM II (Germany) [160].
in effect.\textsuperscript{378} It does not ‘factually contradict’ supremacy, and ‘a substantial risk to the uniform application of [EU] law does not result.’\textsuperscript{379} It merely ensures that the conferral of competences is ‘reserved to the directly declared will of the [national] people alone.’\textsuperscript{380} Negative rulings by the German,\textsuperscript{381} French,\textsuperscript{382} Irish,\textsuperscript{383} Cypriot,\textsuperscript{384} and Czech constitutional courts,\textsuperscript{385} for example, have simply had the effect of returning the matter back to the legislator to ratify what was otherwise thought to be an \textit{ultra vires} act. In \textit{Solange I (Germany)}, the BVerfGE conserved:

‘Invoking such a conflict is, therefore, not in itself a violation of the Treaty, but sets in motion inside the European organs the Treaty mechanism which resolves the conflict on a political level.’\textsuperscript{386}

The normative claim of EU supremacy does not therefore provide an authoritative statement of the law as it will be applied to instruments of fiscal federalism in Member State constitutional orders. As Claes so puts it, ‘None of the constitutional courts has accepted the unconditional supremacy of Community law.’\textsuperscript{387}

1.2.1.3 Positive Evaluation of Member State \textit{Ultra Vires} Review

This thesis is concerned with what \textit{will} happen if machineries of public economics are erected in contested legal territory, not necessarily what should happen. If EU supremacy is to be accepted as the reference system for the purposes of this thesis, EU law must \textit{in fact} provide a reliable account of what is and is not safe ground for the construction of a new federal model. Certainly, expansive \textit{intra}

\textsuperscript{378} \textit{Re Lisbon (Germany)} [216]; \textit{EAW (2735/14) (Germany)} [12(b)]. See: Claes (2015), 197, ‘these situations do not actually concern the principle of primacy… the Treaty is not yet in force and so does not yet claim primacy under EU law.’

\textsuperscript{379} \textit{Re Lisbon (Germany)} [32]: \textit{ultra vires} review ‘does not contradict the principle of sincere cooperation with progressing integration.’

\textsuperscript{380} \textit{Re Lisbon (Germany)} [316]: It ‘is the only way in which a violation of fundamental principles of the constitution can be averted.’

\textsuperscript{381} Prior to ratification of the Maastricht Treaty, the law concerning the 38\textsuperscript{th} amendment of the constitution modified or added eight provisions: Art 23, 24(1a), 45, 50, 52(3a), 88, 1152 (2). \textit{Grundgesetz} (2013).

\textsuperscript{382} \textit{Re Maastricht I (France)} [14], [27], [45], [50], the court held that ‘where ‘international agreements contain a clause contrary to the constitution or infringe the essential conditions for the exercise of national sovereignty, the authorization to ratify those agreements calls for constitutional revision.’ In response to this decision, Art 88(2) was added to the French Constitution, by which France agreed ‘to the transfer of the powers necessary for the establishment of the [EMU], as well as for the fixing of rules concerning the crossing of the external frontiers of the Member States.’ \textit{Re Maastricht II (France)}.

\textsuperscript{383} See, e.g. \textit{Crotty (Ireland)}, 600-601, 611-612, 619-620 (\textit{ultra vires} expansions of EU law must be ratified in the manner provided for the conferral of powers in the Constitution). Kumm, ‘Final Arbiter’ (1999), 361 argues that constitutional prohibition on abortion in Ireland and the constitutional guarantee of abortion in the Netherlands are classic examples of constitutional barriers overcome in the political sphere.

\textsuperscript{384} \textit{After EAW (Cyprus)}, Art 179(2) of the Constitution was amended to imbue EU law with an equivalent normative force to the constitution, in order to make the European Arrest Warrant constitutional.

\textsuperscript{385} \textit{Lisbon I (Czech Republic)}.

\textsuperscript{386} \textit{Solange I (Germany)} [2]. See also: Preshova (2012), 297, if the legal conflict cannot be resolved, ‘perhaps the solution should be sought in political institutions.’

\textsuperscript{387} ‘None of the constitutional courts has accepted the unconditional supremacy of Community law.’Claes, \textit{National Courts' Mandate} (2006), 261. See also: Kaczorowska (2013), 239 ‘The principle of supremacy has limitations arising from the EU law itself: First, the EU can only act within the limits of its competences; second, under Art 4(2) TEU the EU must respect the national identity of the Member States.’ See also: Preshova (2012), 280; De Witte, 'The Nature of the Legal Order' (2011), 352; Dyevre (2013) 147; Mayer (2009).
vires rulings of the ECJ must not be so constitutionally fraught that they risk destabilising the entire federal fiscal architecture each time they are applied.\textsuperscript{388}

In that regard, it must be recalled that, in all Member States, the constitutional authorisation for the application of EU law is a legislative instrument enacted under a specific constitutional window.\textsuperscript{389} Debates about whether it is legitimate for national courts to conduct \textit{ultra vires} review are, in effect, debates about national constitutions.\textsuperscript{390} Given that this is so, a coercive approach to imposing supremacy in areas considered outside the boundaries of conferral is, with certainty, counter-productive to the goal of the effectiveness and uniformity of the EU legal order.\textsuperscript{391} As Kumm notes, ‘The likelihood that all laws will in fact be applied throughout the community will decrease as the probability that a particular law will be struck down on constitutional grounds by a national court increases.’\textsuperscript{392} Judge Lenaerts concurs: ‘For national constitutional courts, the EU’s commitment to respecting national democracies is an essential element without which European integration would come to an immediate halt.’\textsuperscript{393} Judge Maduro writes:

‘A hierarchical alternative imposing a monist authority of European law and its judicial institutions over national law would be difficult to impose in practical terms and could undermine the legitimacy basis on which European law has developed.’\textsuperscript{394}

Such admissions match closely the statement of the positive law from the Member States – that ‘absolute’ supremacy cannot be forced without jeopardising the integrity of the Union itself. The BVerfGE states:

\textsuperscript{388} As De Witte, 'The Nature of the Legal Order' (2011), 346 observes, ['T]he crucial element for the effective application of the principles of primacy and direct effect is the attitude of the national courts and authorities. it is not enough for the [ECJ] to proclaim that EU law should have direct effect and prevail over national law: to put it bluntly, the ECJ can say whatever it wants, the real question is why anyone would heed it.’ See also Weiler, 'Europe's constitutional Sonderweg' (2003), 20, noting that: ‘The European judge … must understand that, in the peculiar constitutional compact of Europe, his decision will take effect only if obeyed by national courts.’

\textsuperscript{389} Maduro, 'Europe and the constitution' (2003), 97: ‘A hierarchical alternative imposing a monist authority of European law and its judicial institutions over national law would be difficult to impose in practical terms and could undermine the legitimacy basis on which European law has developed.’ citing Damien Chalmers, 'Judicial Preferences and the Community Legal Order' (1997) 60 MLR 165, 180. See also: Albi (2007), 29, 49.

\textsuperscript{390} For this point, see: Mattias Kumm, 'Rethinking Constitutional Authority: On the Structure and Limits of Constitutional Pluralism' in Atej Avbelj and Jan Komárek (eds), \textit{Constitutional Pluralism in the European Union and Beyond} (Hart Publishing 2012) 38, 50. See, e.g., \textit{Re Lisbon (Germany)} [312] (Member State constitutional courts may not be deprived of their responsibility as guardians of the constitutional empowerment). See also: Cahill (2011), 94 ‘the only legal outcome one can expect … is that the national judges will honour the oath they swore to uphold the national constitution.’

\textsuperscript{391} Weiler, 'Europe's constitutional Sonderweg' (2003), 487-488; Jukka Snell, 'Gauweiler - Some Institutional Aspects' (2015) 40 EL Rev 133 (the best way to avoid a constitutional conflict between national and EU legal orders ‘is to ensure that the clash never takes place’); Chalmers (1997), 180 (‘the regime is able to develop provided it does not significantly disrupt the egalitarian relations enjoyed between national courts and the Court of justice.’)


\textsuperscript{394} Maduro, 'Europe and the constitution' (2003), 97.
‘[I]t is not enough simply to speak of the “precedence” of Community law over national constitutional law in order to justify the conclusion that Community law must always prevail over national constitutional law because, otherwise, the Community would be put in question.’

However repugnant one might find them, the ‘ultra vires’ review jurisdictions of the Member States are here to stay. In Sugar Quotas (Czech Republic), the Ústavní Soud (citing seven judgements from four countries) pointed out that both old and new Member State constitutional courts ‘have never entirely acquiesced in the doctrine of the absolute precedence of Community law over the entirety of constitutional law.’ In EAW (Germany), the BVerfGE (citing 27 judgements from 10 countries), makes a similar point:

‘The overwhelming majority of the constitutional and supreme courts of other Member States shares for their respective sectors in the view of the [BVerfGE] that the application of primacy of Union law is not unlimited, but that are drawn do it by the national (constitutional) limits.’

For the purposes of this thesis, this must be decisive. As Steiner & Woods conclude, ‘all the constitutional courts of the Member States regard themselves as having the power to review the boundary of EU competence.’ Surveys by Grabenwarter, De Witte, Claes, and others reach similar conclusions.

For the architects of fiscal federalism, it would be foolish to proceed on the cheerful basis that Member States wouldn’t dare apply the jurisdictions they have set out. The imposition of ‘absolute’ EU supremacy has, in fact, triggered some of these jurisdictions - with immediate and deleterious effect on the uniformity and effectiveness of EU law. In 2013, for example, the ECJ’s ruling in Melloni v Ministerio Fiscal provoked the BVerfGE into exercising its Solange I (Germany)

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395 Solange I (Germany).
396 See, e.g., Re Lisbon (Germany) [310]-[312]: Constitutional courts tion ‘may not, within the limits of the competences conferred on them—as is the position of the Basic Law—be deprived of the responsibility for the boundaries of their constitutional empowerment for integration and for the safeguarding of inviolable constitutional principles.’
397 Sugar Quotas III (Czech Republic) VI(A). See also [A-3B]: ‘delegation of a part of the powers of national organs may persist only so long as these powers are exercised in a manner compatible with the foundations of state sovereignty.’
398 EAW (2735/14) (Germany) [1](2)(c)
400 Grabenwarter (2011) concludes: ‘in most of the countries investigated, the case law of the (constitutional) courts determines their relationship or exact demarcation between constitutional law and European Community law.’
401 De Witte, ‘The Nature of the Legal Order' (2011), 352, ‘The thesis defended by the [ECJ] that Union law has absolute primacy … is generally not accepted by national constitutional and supreme courts.’
402 Claes (2015), 178, 198-199: Assertions of ultra vires review ‘are numerous and they are increasing… virtually no Member State unconditionally accepts the principle of primacy as propounded by EU law.’ See also: Preshova (2012), 280: ‘the primacy of EU law over constitutions, or at least their fundamental provisions, has been continuously and persistently challenged.’ See further: Kaczorowska (2013), 256; Dyevre (2013) 147; Mayer (2009).
403 Even where these conflicts are latent, to presume the acceptance of EU supremacy in relation to Kompetenz-kompetenz ‘would be to assume that a static position fully represents a potentially dynamic relationship.’ William Phelan, ‘Can Ireland legislate contrary to European Community law?’ (2008) 33 EL Rev 530, 548.
jurisdiction for the first time since 1973, invalidating an act of EU law under national constitutional rights grounds.\footnote{In that case, the BVerfGE explicitly rebuffed the CJEU’s Melloni decision before overturning a decision of a German Higher Regional Court, even though ‘the Higher Regional Court’s decision is determined by Union law.’ EAW (2735/14) (Germany) [76]-[78]. See: Melloni [58]-[59]; Case C-399/11 Melloni v Ministerio Fiscal (AG Bot, 2 October 2012) [137]-[142]. For comment: Leonard Besslink, ‘The parameters of constitutional conflict after Melloni’ (2014) 39 EL Rev 531.} Similarly, in 2012, a straight application of supremacy to Czechoslovakian dissolution arrangements led to the first open ultra vires declaration of a ruling of the ECJ in the Ústavní Soud.\footnote{Slovak Pensions XVII (Czech Republic). For criticism: Jan Komárek, ‘Czech Constitutional Court Playing with Matches: the Czech Constitutional Court Declares a Judgment of the Court of Justice of the EU Ultra Vires; Judgment of 31 January 2012, Pl. US 5/12, Slovak Pensions XVII (2012) 8 EuConSt 323.} In Anti-terror Database (Germany), the BVerfGE issued an explicit rebuke to the ECJ’s ruling in Åkerberg Fransson, refusing to submit a reference in an area partially governed by EU law and appearing to state that the Fransson ruling (seen by some as an extension of EU competence)\footnote{See, e.g., Data Retention (Germany) (Cases 1 BvR 256, 263 and 586/08) available in English at: <wwwbverfgde/20130424_1bvr121507enhtml> accessed 22 May 2016 (BVerfGE) declaring national implementing measures of an EU directive invalid, but doing so on the basis that the discretion afforded under the Directive had been used in an unconstitutional way (although there was little scope for discretion). For comment: Anna-Bettina Kaiser, ‘German Data Retention Provisions Unconstitutional in Their Present Form’ (2010) 6 EuConst 203. See also: EAW (2735/14) (Germany) (invalidating the national implementation of a European arrest warrant); Gauweiler I (Germany); Gauweiler III (Germany) (placing six conditions on the application of the ECB’s OMT programme); EAW (Cyprus) (national implementation of EAW Framework Decision unconstitutional); EM (Eritrea) (UK) (interpreting the CJEU’s ruling in NS (Afghanistan) on article 4 of the Charter in conformity with the Human Rights Act 1998 (rather than the other way around); Attorney General v X (Ireland) [1992] 1 IR 1 (right to life not subject to free movement provisions).} was itself ultra vires and inapplicable in Germany:

‘[T]he Court of Justice is not the lawful judge according to Art.101(1)GG. The ECJ’s decision in the case Åkerberg Fransson does not change this conclusion… [Fransson] must not be read in a way that would view it as an apparent ultra vires act … in a way that questioned the identity of the Basic Law’s constitutional order.’\footnote{Kumm, ‘The Jurisprudence of Constitutional Conflict’ (2005), 269. NB: this does not mean that EU law is not supreme, it merely means that EU law is supreme over national law as a consequence of the national constitutional law itself.}

The jurisprudence cited in this Chapter is replete with examples of EU law bending around constitutional guarantees at the margins of competence.\footnote{Lorna Woods and Watson (2012), 101-102.} As Kumm points out: ‘National Constitutional Supremacy is a legal rule that governs practice as a matter of fact, and that is all there is to it.’\footnote{Meloni v Ministerio Fiscal (2012) 8 EuConSt 323.} 1.2.2 The Constitutional Identity Review Jurisdiction

The second limitation imposed by national constitutional law on the European legal order is an absolute one: Not only have some powers simply not been conferred the EU, but, according to constitutional rulings in nineteen countries, some powers can never be transferred to the EU. These
are typically referred to as the limits of ‘constitutional identity’ – inviolable, unconferring powers or principles so integral to the constitutive existence of the national legal order that they remain beyond the amending power itself.\footnote{410 Grabenwarter (2011), 94 concludes: ‘The vast majority of Member States have an inviolable core of basic constitutional principles or emphasise the autonomy of fundamental rights.’}

The unamendable ‘eternity clause’ in the 1949 German Constitution is perhaps the most notorious in this respect, but many other national constitutional authorities have also asserted some ‘inviolable core’ integral to the constitution. The German BVerfGE,\footnote{411 EAW (2735/14) (Germany) [1](b): ‘The precedence [of EU law] only applies insofar as the Basic law and the Act of Ascent permit or provide for the transfer of sovereignty rights. Its scope is limited by the Basic Law’s constitutional identity that … is neither open to constitutional amendments nor to European integration.’ See also: Re Lisbon (Germany) [210]-[211]: ‘The obligation under European law to respect the constituent power of the Member States as the masters of the Treaties corresponds to the non-transferable constitution (art.79.3 BL), which is not open to integration in this respect.’ See further: Brunner (Germany) [52]; Re Honeywell (BVerfGE) [40]: Aid Measures for Greece (Germany) [99]-[101]; ESM I (Germany) [150], [193]; Anti-terror Database (Germany) [91]; Gauweiler I (Germany) [25]-[27].} the Czech Ústavní Soud,\footnote{412 Act on the Lawlessness of the Communist Regime Pl US 19/93 (12 December 1993) available at: <www.wnalusoudez> accessed 12 July 2016 (Ústavní Soud); Sugar Quotas III (Czech Republic) [A-3B]; Lisbon I (Czech Republic) [91], [93]. (‘These principles cannot be touched even by an amendment to the Constitution implemented formally in harmony with law…’); Lisbon II (Czech Republic), (refusing to catalogue a list of such powers, the court asserted that it would consider potential intrusions on a case by case basis), [111]-[113].} The Danish Højesteret,\footnote{413 Re Maastricht I (France) [9]-[10], [16]; Constitution for Europe (France) [7], [24], [29]; Re Elections to the EP (France), 315; Re Treaty of Amsterdam (France) Decision No 97-394 DC (31 December 1997) in Oppenheimer, The Cases (Vol 2) 219 [1]-[7]; Re Lisbon (France) [9] [16]; Loi sur l'intégration (France) [45]; and Société de l’information [19]: ‘the transposition of a Directive cannot run counter to an rule or principle inherent to the constitutional identity of France.’} the French Conseil Constitutionnel,\footnote{414 Agricultural Surplus Stocks (Hungary) (implementation of a Commission Regulation unconstitutional under prohibition on retroactivity); Lisbon (Hungary) (sovereignty provisions of the constitution supreme over EU law.} the Hungarian Magyarország Alkotmánybírósága,\footnote{415 Frontini (Italy) [21]; Granital (Italy) [7]; Fragd (Italy), 545 (‘Neither, in the presence of a possible infringement of a fundamental principle, is it possible to invoke the overriding considerations of the uniform application of Community law and the certainty of law’); Sardianian Taxes Reference (Italy) Order no 103/2008 (13 February 2008) <http://wwwcorteconstituzionale> accessed 18 May 2016 (Corte costituzionale) [6]-[7] (referring to the inviolability of the fundamental principles of the constitutional order and the inviolable rights of man guaranteed by the Constitution.) See also: UN Convention (Italy), at [3.2]; ‘[T]here is no doubt that the fundamental principles of the constitutional order and inalienable human rights … serve as “counter-limits”’ [controlimit] to the entry of European Union law.’} the Irish Supreme Court,\footnote{416 Accession Treaty (Poland), grounds 13-14; EAW (Poland), grounds 4, 8; Lisbon (Poland), grounds 2.1-2.4: ‘constitutional identity is a concept which determines the scope of “excluding - from the competences to confer competences - the matters which constitute … ‘the heart of the matter’, i.e., are fundamental to the basis of the political system of a given state”, the conferral of which would not be possible pursuant to Art 90 of the Constitution.’} the Italian Corte costituzionale,\footnote{417 Tothburn v Sunderland CC (UK) [69] per Laws LJ ‘Thus there is nothing in the [European Communities Act] which allows the [European Court] or any other institutions of the EU, to touch or qualify the conditions of Parliament’s legislative supremacy in the United Kingdom… because by our law it could not allow it.’} the Spanish Tribunal Constitucional,\footnote{418 ESM (Austria) the VfGH held that a transfer of ‘specific Federal competences’ under Art 9(2) of the Austrian required that the amount provided for under the ESM Treaty was limited. This could imply that a similar open-ended commitment} the Polish Trybunał Konstytucyjny,\footnote{419 DILKATSA (Greece), 300-304.} the UK Supreme Court,\footnote{420 ESM (Austria) the VfGH held that a transfer of ‘specific Federal competences’ under Art 9(2) of the Austrian required that the amount provided for under the ESM Treaty was limited. This could imply that a similar open-ended commitment} the Greek Council of State,\footnote{421 ESM (Austria) the VfGH held that a transfer of ‘specific Federal competences’ under Art 9(2) of the Austrian required that the amount provided for under the ESM Treaty was limited. This could imply that a similar open-ended commitment} the Austrian Verfassungsgerichtshof,\footnote{422 ESM (Austria) the VfGH held that a transfer of ‘specific Federal competences’ under Art 9(2) of the Austrian required that the amount provided for under the ESM Treaty was limited. This could imply that a similar open-ended commitment} the Lithuanian Konstitucinis
Teismas, Teismas, the Latvian Satversmes tiesa, the Romanian Curtea Constituțională, the Swedish Konstitutionsutskottet, and the Estonian Riikikohus have all asserted that some constitutional powers or principles are not conferrable under the national constitution, either de lege lata or at all.248

These constitutional identity jurisdictions are also based on intuitive logic: Under Articles 4(1), 5(1)229 and 5(2) TEU, the limits of Union competences are governed by the principle of conferral, and under Articles 48(4) TEU, 49 TEU, 54 TEU, and 357 TFEU, the EU acquires its competences when the Treaties are ‘ratified by the High Contracting parties in accordance with their respective constitutional requirements.330 Put simply, powers bestowed on the EU are carved out from national state constitutions and, nemo plus iuris transfere (ad alium) potest quam ipse habet, state institutions cannot give what they do not have.331 The Polish Tribunal Konstytucyjny encapsulates the jurisprudence thusly:

would be unconstitutional under the Act of Accession, as it would have been under Art 9(2). Under Art 44(3) of the Austrian constitution, any amendment to the fundamental principles require a total revision of the Constitution. See also: Government of Austria report on the Act of Accession, as translated in Nigel Foster, Austrian Legal System & Laws (Cavendish Publishing 2003) , 144 (‘the fixed core of Austrian constitutional law cannot be changed by Community law nor indeed be required to be interpreted in the light of [EU] law’).

242 Referendums (Lithuania) [2.4], [3.3.1].
243 Re Lisbon (Latvia), 54, 58. ‘Consequently, delegation of competencies cannot exceed the rule of law and the basis of an independent, sovereign and democratic republic based on the basic rights.’
244 In Romania, the Curtea Constituțională has invalidated EU law where it is in conflict with EU law, however it has only done so directly (under the pretense of invalidating the national implementation only) and the Constitution is supreme over international treaties. Therefore, it is not clear what the precise scope of the identity is. See: Data Retention (Romania).
245 Konstitutionsutskottet, (1993), 27. In AAA v Strix (Sweden) the Supreme Court defended the protection of freedom of expression by treating the case as an issue of purely national law and refusing to submit a preliminary reference, even though this was argued to be a matter of prima facie national discrimination.
246 The CEEA contains a constitutional safeguard clause, which allows membership in the Union ‘provided the fundamental principles of the [Constitution] are respected.’ See: Opinion on the Interpretation of the Constitution (Case No 3-4-1-3-06) of 11 May 2006 (English version) (Riigikohus põhiseaduslikkuse järellevälve kolleegium) (Supreme Court Constitutional Review Chamber), per Kergandberg J and Köve J; ESM (Estonia) [222].
247 Also of note, Finland’s constitution contains a constitutional safeguard clause in (s 94(3)), and the Constitutional Committee will enforce the principle of democratic Kompetenz-kompetenz against ultra vires institutions: Opinion on the ERM (Finland). For a survey, see: Griller (2001), 166-167. The Slovene constitution contains a constitutional safeguard clause (Art 3a) but this has not yet given rise to constitutional identity jurisprudence.
248 Art 5(1) states: ‘The limits of Union competences are governed by the principle of conferral.’
249 See also: Art 42(2) TEU (decision on a common defence); Art 50(1) TEU (unilateral withdrawal); Art 25 TFEU (amendment of the rights in Art 20(2) TFEU); Art 223(1) TFEU (amendment of parliamentary election period); Art 262 TFEU (conferral of jurisdiction in intellectual property rights); Art 311 TFEU (amendment of own resources); Art 40.2 Statute of the ESCB.
250 ‘No one can transfer more rights (to another) than he himself has.’ See: Fellmeth and Horwitz (eds), (2009).
251See, for statements to that effect: Germany: Re Lisbon (Germany) [221] (transfers of German constitutional bodies subject to Arts. 20 and 79 German BL). Denmark: Carlsen (Denmark) [13] (‘the authorities of the realm have themselves no such power.’) Poland: ESM & TSGC (Poland) [6.3.1] (Art 90 of the Polish Constitution cannot ‘constitute a basis of conferring … competence to enact legal acts or take decisions that would be inconsistent with the Constitution.’).
252 Ireland: Croddy (Ireland), 783 (‘If it is now desired to qualify, curtail or inhibit the existing sovereign power… it is not within the power of the Government itself to do so’); Collins (Ireland) [95]-[98].
‘Constitutional identity is a concept which determines the scope of excluding – from the competence to confer competences – the matters which constitute … “the heart of the “matter,”’ i.e., are fundamental to the political system of a given state.’

For the architects of European fiscal federalism, this presents a dilemma. This is so because, under Article 4(1) TEU, the ECJ has reserved for itself the exclusive jurisdiction to deliver binding rulings on whether the EU’s duty to respect ‘national identity’ is met. Under that jurisdiction, the ECJ openly disavows the interpretation that Article 4(1) TEU allows constitutional identities to limit the scope of EU law. As Judge Lenaerts has written, ‘There simply is no nucleus of sovereignty that the Member States can invoke, as such, against the Community’ - even when the Treaty expressly acknowledges the existence of residual powers for the Member States.

Thus, the (Member State) ‘constitutional identity’ and (EU) ‘national identity’ jurisdictions derive from different legal orders; they protect different normative values; and they draw very different red lines around the contours of EU competence. The (ECJ) construes its national identity jurisdiction as a mandate to restrict identity claims invoked within the EU legal order prevent such claims from boring unjustified derogations into EU law. The (Member State) constitutional identity jurisdiction defines what may never be conferred on the Union and is therefore outside the bounds of EU law altogether. The Union can have no powers other than what the Member States have given it, and what the Member States have given it is limited by their own constitutional identities.

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433 Lisbon (Poland), 202.
434 ‘The Union shall respect the equality of Member States before the Treaties as well as their national identities, inherent in their fundamental structures, political and constitutional, inclusive of regional and local self-government. It shall respect their essential State functions, including ensuring the territorial integrity of the State, maintaining law and order and safeguarding national security. In particular, national security remains the sole responsibility of each Member State.’ Until Lisbon, Art F(1), Treaty on European Union [1992] OJ C 191/1 read, ‘The Union shall respect the national identities of its Member States, whose systems of government are founded on the principles of democracy.’
435 ‘National identities’ includes the constitutional identity. See, e.g., Michaniki (Opinion of AG Maduro) [31] (‘The national identity clearly includes the constitutional identity of the Member State’)
436 The duty to ‘respect’ in Arts 7, 11(2), 13(3), 22, 25, 26, 34(1), 34(2), 36, 48(2) of the Charter is interpreted as allowing proportionate interferences with the protected right (see Art 52(1) of the Charter), von Bogdandy and Schill (2011), 1141; Elke Cloots, National Identity in EU Law (Oxford University Press 2015), 190-191.
438 For the Member States, it is only ‘the violation of the European legal order [which] triggers the review of other constitutional principles.’ Kumm, ‘Final Arbiter’ (1999), 382. See, e.g., Re Lisbon (Germany) [201], [216]. There has been some recognition of this at EU level. In Gauweiler II (Opinion of AG Cruz-Villalón) [34] AG Villalón acknowledged: “[A] constitutional criterion of that kind, which is subsequently used by the BVerfGE in its assessment, is said to consist in both the unalterable core content of the national constitution (“constitutional identity”, as enshrined in Art 79(3) BL), and the principle of conferral of powers (with the logical consequences for “ultra vires” EU acts…). It seems that these two constitutional criteria, far from being mutually exclusive, are each able to provide support for the other…. Such criteria for reviewing validity, by definition, may be applied only by the BVerfGE itself.”
439 Re Lisbon (Germany) [319] (EU powers are given by national acts, which can only be given within the limits of the current constitutional order).
The question therefore arises: ‘who decides whether Article 4(2) TEU has been infringed and what the legal consequence of a possible infringement are?’ In simple, this section is concerned with whether - as the ECJ maintains - it is now the sole and final arbiter of what is and is not an infringement of constitutional identity, capable of ‘ousting’ the jurisdictions of Member State courts; or whether Member State courts may still threaten proposed machineries of public that intrude on their constitutional identities. The answer depends on whether Article 4(2) TEU amounts to a ‘formal’ competence to interpret constitutional identity, or whether that jurisdiction is only material - it has ‘only persuasive authority.’

1.2.2.1 Constitutional Evaluation of Constitutional Identity Review

In order to evaluate this question, the first task must be to compare the constitutional authority for the application of these jurisdictions. In that regard, the constitutional basis for the ECJ’s of ‘national identity’ jurisdiction is Article 4(2) TFEU - a provision of EU law. Introduced at Maastricht as an attempt to ‘counterbalance the Union’s federal vocation,’ it reads:

‘The Union shall respect the equality of Member States before the Treaties as well as their national identities, inherent in their fundamental structures, political and constitutional, inclusive of regional and local self-government. It shall respect their essential State functions, including ensuring the territorial integrity of the State, maintaining law and order and safeguarding national security.’

On the other hand, the constitutional basis for Member State ‘constitutional identity’ jurisdictions both predates, and remains entirely separate from, the ‘national identity’ jurisdiction under 4(2) TEU. Constitutional identity jurisprudence dates to Frontini (Italy) (1973) and Solange (Germany) (1974) in which the Corte costituzionale asserted controlimiti to EU law, and BVerfGE asserted that conferral ‘does not open the way to amending the basic structure of the Basic law, which forms the basis of its identity.’ In the European Union, the duty to respect ‘national identities’ was not

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441 Winner Wetten [67] referring to ‘the ousting effect which a directly-applicable rule of Union law has on national law that is contrary thereto...’CE: Re Lisbon (Germany) [211], [216].
442 Schilling (1996), 407: Within the scope of EU law, the CJEU’s power is formal – it has sole competence to interpret EU law, rightly or wrongly. Outside of EU law, its power is material – its rulings will be accepted so long as they are rightly decided.
443 Jans-Herman Reestman, ‘The Franco-German Constitutional Divide: Reflections on National and Constitutional Identity’ (2009) 5 EUConst 267, 269. Article 4(2) TEU evolved from the ‘Christophersen clause’ developed during the Constitutional Convention, the purpose of which was to pre-empt competence creep: Preshova (2012), 274-276 (‘showing that the external limit on the exercise of the Union’s conferred powers are the fundamental constitutional structures of the Member States’); Michaniki (Opinion of AG Maduro) [30] (‘a reminder of the obligation [was] regarded as necessary by the Member States’); von Bogdandy and Schill (2011), 1425 (‘The identity clause... reflects the determination of Member States to assert themselves as relevant and autonomous political actors in the European legal procedures’).
445 Frontini (Italy) (1973); Solange I (Germany) (1974) [3]. In France, the Conseil Constitutionnel has long asserted fundamental limits of sovereignty on the EU legal order from an ‘exeress contrary provision’ of the Constitution, but became to refer to provisions or principles ‘inherent to France’s constitutional identity’ in Constitution for Europe
introduced until Maastricht (1992), and did not become an active ground for derogation until Lisbon (2009).

Of the twenty-seven constitutions examined in this chapter, nineteen constitutional authorities have developed a set of integral constitutive structures or principles beyond the competence of the amending power of the legislator.446 These constitutional bases and jurisdictions be catalogued here only in brief. However, the point to be extracted from this survey is that, as matter of pure constitutional law, these jurisdictions do not derive from a normative mandate to balance constitutional values against the effectiveness of EU law (as the ECJ’s ‘national identity’ jurisdiction does).447 They derive from the very existence of immutable and inalienable constitutional structures that cannot be - and therefore have not been – conferred on the Union at all. They are outside the EU legal order altogether.

In Germany, constitutional identity inheres in Article 79(3) BL, the so-called ‘eternity clause’ of the 1949 constitution, shielded by an additional layer of protection in the form of a constitutional safeguard clause (Article 23 BL) which makes clear that conferral is subject to the eternity clause.448 The ‘eternity clause’ permanently shields the highest principles of the German state - human dignity (Article 1 BL) and the democratic social and federal state (Article 20 BL) - from constitutional change.449 As these principles are inviolable, nemo plus iuris, the supremacy of EU law cannot prevail over these principles.450 In Re Lisbon (Germany), the BVerfGE set out its constitutional identity jurisdiction as follows:

‘From the perspective of the principle of democracy, the violation of the constitutional identity codified in art.79.3 of the Basic Law is at the same time an encroachment upon the constituent power of the people. […] No constitutional body has been granted the power to amend the

(France) [88], [92]. Spain enunciated its doctrine the same time Constitutional Treaty (Spain). Similarly, British parliamentary sovereignty has been an inviolable constitutional structure which simply cannot be conferred, and is outside the European legal order altogether since its accession in 1973.

446 In the remaining eight countries, a clear line of constitutional identity jurisprudence has not developed, either because openness to international law itself constitutes part of the national identity (the Netherlands and Luxembourg) or because the entire constitution as a whole is anyways supreme over all EU law (Malta, Cyprus prior to the Fifth Amendment, Belgium, Slovakia, Slovenia, Romania and Belgium).

447 Besides the obvious interpretational differences, there are numerous instances of national and EU courts describing these concepts as qualitatively distinct. In Re Lisbon (Germany), the BVerfGE uses ‘constitutional identity’ to describe the basic precepts of the German constitution, but only uses ‘national identity’ when referring to Art 4(2) TEU. Cf: Michaniki (Opinion of AG Maduro) [31], ‘The national identity clearly includes the constitutional identity of the Member State’. For an analysis of the CJEU’s ‘constitutional identity’ case law, see: Reestman (2009); Koen Lenaerts, ‘How the ECJ Thinks: A Study on Legitimacy’ (2013) 36 Forham Int'l LJ 1302, 1326-1342; Preshova (2012), 283.

448 Art 23(1) Grundgesetz (2013) states: ‘To realize a unified Europe, Germany participates in the development of the European Union which is bound to democratic, rule of law, social, and federal principles as well as the principle of subsidiarity and provides a protection of fundamental rights essentially equivalent to that of this Constitution. The federation can, for this purpose and with the consent of the Senate [Bundesrat], delegate sovereign powers. Article 79(1) & (3) is applicable for the foundation of the European Union as well as for changes in its contractual bases and comparable regulations by which the content of this Constitution is changed or amended or by which such changes or amendments are authorized.’

449 See below, Section 1.3. Re ESM I (Germany) [203].

450 Aid Measures for Greece (Germany) [101]; Re Lisbon (Germany) [196], [204].

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constitutional principles which are essential pursuant to art.79.3 of the Basic Law. The Federal Constitutional Court monitors this. Through what is known as the eternity guarantee, the Basic Law reacts on the one hand to the historical experience of a creeping or abrupt erosion of the free substance of a democratic fundamental order. […] [The BVerfGE] reviews whether the inviolable core content of the constitutional identity of the Basic Law pursuant to art.23.1 in conjunction with art.79.3 of the Basic Law is respected.'

In France, the ‘identité constitutionelle de la France’ is assimilated to the ‘conditions essentielles d’exercice de la souveraineté’ which finds textual expression in the preamble to the 1958 Constitution and the title on sovereignty, and the ‘structures constitutionnelles’ of the ‘indivisible, secular, democratic and social Republic.’ The constitution cannot be amended by other than the pouvoir constituent in accordance with the constitution, and cannot be subordinate to a superior norm, including EU law. This means that the Kompetenz-kompetenz cannot be conferred, and EU law ‘cannot run counter to an rule or principle inherent to the constitutional identity of France, except when the constituting power consents thereto.’ EU law may apply within a constitutional space that has been cleared by the pouvoir constituent, but the constitution remains in effect over EU

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451 Re Lisbon (Germany) [194], [205], [216].
453 The preamble to the 1958 Constitution reads: ‘The French people solemnly proclaim their attachment to the Rights of Man and the principles of national sovereignty as defined by the Declaration of 1789, confirmed and complemented by the preamble to the constitution of 1946.’ The Declaration of the Rights of Man and of the Citizen of 1789 states that, ‘the basis of all sovereignty essentially resides in the Nation,’ and Article 3 of the Constitution of 1958 states that ‘national sovereignty belongs to the people who shall exercise it through their representatives and by means of a referendum.’ Art 89 of the Constitution of France reads: ‘The republican form of government shall not be the object of any amendment.’.
454 See: Re Elections to the EP (France), 315; Re Maastricht I (France) [9]-[10]; Re Amsterdam (France) [1]-[7]; Constitution for Europe (France) [1]-[2], [7], [13]; Re Lisbon (France) [1]-[9]; Loi transposant les directives gaz et électricité (France) Decision No 2006-543 DC (30 November 2006) (Conseil Constitutionnel); Re Lisbon (France) [1]-[9]; The Bioethics Act Decision No 2004-498 (29 July 204) (Conseil Constitutionnel) (ruling that the implementation of a Directive could not conflict with a rule inherent to the French constitutional identity - freedom of expression is guaranteed by Art 11 of the Declaration of 1789).
455 See, e.g., Sarran et Levacher (France) (the French constitution is supreme over the International Covenant on Civil and Political Rights and ECHR); Société Arcelor Atlantique et Lorraine (France) Req No 287110 (Conseil État) (if the constitutional value is protected under EU law, the Conseil d’État will refrain from examining the EU law. If there is no such a protection, the national judge will directly examine the constitutionality of the implementing measures).
456 In Re Elections to the EP (France), 315, the Conseil d’État emphasized that that ‘no provision of a constitutional nature allowed all or part of national sovereignty to be transferred to any international organisation.’ Accession to the Union was lawful because the European Parliament ‘does not have the effect of creating either a sovereign body or institutions whose nature would be incompatible with respect for national sovereignty.’ See also: Constitution for Europe (France) [24]; Re Lisbon (France) [18]. See further: Theil (2014), 612; and Richards (2006), 511 (arguing that the constituent power could not amend the constitution to make the constitution subordinate to a superior norm).
457 EU law will run counter to a rule or principle inherent to the constitutional identity of France where it is contrary to an ‘express contrary provision’ of the constitution which has not been amended by the pouvoir constituent dérivé: Société de l’information (France) [19]. See also: Re Maastricht I (France) [14], [27], [45], [50] where ‘international agreements contain a clause contrary to the constitution or infringe the essential conditions for the exercise of national sovereignty, the authorization to ratify those agreements calls for constitutional revision.’ See further: Re Amsterdam (France) [7], [27], [31]-[33]; and Constitution for Europe (France) [7]. See also: As Groussot (2008), 105.
law in so far as it has not been so amended. 458 In Constitution for Europe (France), the Conseil Constitutionnel confirmed that EU supremacy ‘in no way modifies the nature of the European Union, nor the scope of the principle of the primacy of Union law as duly acknowledged by Article 88-1 of the Constitution.’ 459 This position has been consistently repeated since. 460 Neither the Cour de Cassation, 461 the Conseil Constitutionnel, 462 nor the Conseil d’État 463 recognise the normative supremacy of EU law over the constitution itself. The Conseil Constitutionnel has repeatedly held that the authorisation in Article 88-1 does not grant supremacy over the constitution, nor precludes ‘the review of statutes for the purpose of verifying their conformity with the Constitution, which is incumbent upon [the French courts].’ 464 The Conseil Constitutionnel has furthermore rejected the contention that ECJ adjudication could protect the ‘identité constitutionelle de la France’, and has refused to abdicate its adjudicative authority. 465 The reason for this is the principle of popular sovereignty: Article 3 of the 1958 Constitution states that ‘national sovereignty belongs to the people … no section of the people nor any individual may arrogate to itself, or to himself, the exercise thereof.’ 466

In Italy the Corte costituzionale has held since 1973 that ‘fundamental principles of the Italian Constitution’ imposed controllimiti (counter-limits) on EU law, and that the court would ‘always control the continuing compatibility of the Treaty with fundamental principles.’ 467 This was re-asserted 16 years later in Fragd (Italy), when the court held that the uniformity and effectiveness of EU law certainly did not have any overriding force against fundamental constitutional principles. 468

458 As Reestman (2009), 390 observes, ‘the Conseil will not only exert a identity review on secondary Union law, but also the “normal” constitutionality test it exerts on treaty law before ratification. This ... does not differ as fully from that of the Constitutional court, with its identity and ultra vires review.’ See also Thiel (2014), 606.

459 Re Constitution for Europe (France) [13]

460 In Re Lisbon (France) [7]-[9], it was only Art 88-1 that allowed France to ‘participate in the creation and development of a permanent European organisation.’ In Loi sur l'intégration (France) [9] the Conseil Constitutionnel held that Art 88-1 ‘confirm[s] the place of the Constitution at the pinnacle of the national legal order...’ See also: Jacques Valbre (France) [4]; Bioethics Act (France); and Constitution for Europe (France) [24]: ‘clauses of the Treaty which transfer to the [EU] powers affecting the essential conditions for the exercise of national sovereignty in areas or on terms other than those provided for in the Treaties referred to in article 88-2 require a revision of the constitution.’

461 Jacques Valbre (France); Mile Fraisse (France).

462 Constitution for Europe (France) [13]; Re Lisbon (France) [8]-[9]. See: Bell (2005); Jan Herman Reestman, 'France: Conseil constitutionnel on the status of (secondary) Community law in the French internal order' (2005) 1 EuConst 302.

463 Nicolò (France); Re Elections to the EP (France); Cohn-Bendit (France) (refusing to accept the direct effect of a directive); Sarran et Levacher (France). See: Claudina Richards, 'Sarran et Levacher: ranking legal norms in the French Republic' (2000) 25 EL Rev 192.

464 Re Lisbon (France) [7]-[9]; Société de l'information (France) [19]-[20]; Loi sur l'intégration (France) 9.

465 Re Amsterdam (France) [4], [23]: ‘The application of [those] principles does not, of itself, prevent those transfers of powers authorized by the Treaty and submitted to the Constitutional council for examination from having such a broad ambit and taking effect in such a manner as to affect the essential conditions for the exercise of national sovereignty.’ See also: Constitution for Europe (France) [25]; Re Lisbon (France) [19]; Société de l'information (France) [19].

466 Constitution of France, 315; Re Maastricht II (France) [9]-[10]; Re Amsterdam (France) [1]-[7]; Constitution for Europe (France) [1]-[2]; Re Lisbon (France) [1]-[9]; TSGC (France) [5]-[9].

467 Frontini (Italy) [21]: ‘it is hardly necessary to add that by Art 11 of the Constitution limitations of sovereignty are allowed solely for the purpose of the ends indicated therein.’ See also: Sardinian Taxes (Italy) [8.2.8.1].

468 Fragd (Italy), 545: ‘Neither, in the presence of a possible infringement of a fundamental principle, is it possible to invoke the overriding considerations of the uniform application of Community law and the certainty of law.’
As held in ECHR (Italy), the inalienable rights of man,\(^{469}\) and the fundamental principles of the democratic Republic,\(^{470}\) simply ‘cannot be considered a “field” in relation to which it is possible for the state to relinquish its sovereign powers.’\(^{471}\) This precludes an amendment or disposition of power other than provided in the Constitution, or an extra-constitutional Kompetenz-kompetenza.\(^{472}\) The Corte costituzionale explicitly rejects the ECJ’s authority to adjudicate on Italian controlimiti - 'any different solution goes against the exclusive competence given by the Constitution to this Court.'\(^{473}\) A violation of these unconferrable principles will result in a declaration of invalidity, or if the Treaty is itself interpreted in conflict with the Constitution, ‘the radical and disruptive remedy of withdrawal from the European Union.’\(^{474}\)

In Spain, the Tribunal Constitucional also recognizes an ‘essential nucleus of powers,’\(^{475}\) which impose ‘material limits imposed on the transfer [to the EU] itself.’\(^{476}\) As in Germany and Italy, Spanish constitutional identity encompasses both constitutional reserves of democratic power and fundamental rights.\(^{477}\) This derives not from their normative superiority, but from an inability to confer them in the first place.\(^{478}\) In Maastricht (Spain), the Tribunal held that the authority to confer powers under Section 93 of the Constitution could not provide a basis for the conferral of powers incompatible with the core provisions of the Constitution,\(^{479}\) and has held since Asepesco (Spain) that

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\(^{469}\) Inalienable human rights encompasses the fundamental principle of human dignity, which precludes acts such as deportation, slave labour, massacres, torture and affords specific protections ‘intrinsically connected to the principle of democracy itself’, such as the right to effective judicial protection. See: UN Convention (Italy) [3.4], ‘the right to effective judicial protection is ‘one of the supreme principles of our constitutional order, intrinsically connected to the principle of democracy itself.’ See also: Filippo Fontanelli and Giuseppe Martinico, ‘Cooperative Antagonists: The Italian Constitutional Court and the Preliminary Reference’ (2008) Eric Stein Working Paper No 5 ; Giorgio Gaja, ‘New Developments in a Continuing Story: The Relationship between EEC Law and Italian Law’ (1990) 27 CMLR 84.

\(^{470}\) The fundamental principles encompass the principle of democracy as it manifests in Article 138 (amendments to the Constitution) and Article 139 (the ‘eternity’ clause of Italy’s status as a republic): Talamucci (Italy), 393.

\(^{471}\) GP, DP, AG and Others v the Municipality of Avellino and the Municipality of Leonforte (Direct Effect of ECHR) (Italy) Judgment No 349/2007 available in English at: <www.cortecostituzionale.it> accessed 22 April 2016 (Corte costituzionale) [6.1]. Similarly, in In Sardinian Taxes Reference (Italy) [8.2.8.1], the court stated that the exercise of powers under Article 11 of the Constitution is transferred ‘subject … to the limit of the inviolability of the fundamental principles of the constitutional order and the inviolable rights of man.’

\(^{472}\) Granital (Italy).

\(^{473}\) UN Convention (Italy) [3.2].

\(^{474}\) Talamucci (Italy), 393. The controlimiti of EU law were reasserted in the Corte costituzionale’s first reference to the ECJ in 2008, and again in UN Convention (Italy) in 2014. See: Sardinian Taxes Reference (Italy) [6]-[7] asserting controlimit, ‘being the inviolability of the fundamental principles of the constitutional order and the inviolable rights of man guaranteed by the Constitution.’; and UN Convention (Italy) [3.2] ‘There is no doubt that the fundamental principles of the constitutional order and inalienable human rights … serve as controlimit to the entry of European Union law.’ See also: Fontanelli and Martinico (2008), 22 ‘In short, the Corte costituzionale ‘did not give up any of its competences, or did it restrict its authority by involving the ECJ; the ICC wishes to find an authoritative/technical support to strengthen its own decision, but no transfer of jurisdiction to the ECJ actually occurred.’

\(^{475}\) Maastricht (Spain), 713.

\(^{476}\) Constitutional Treaty (Spain) [3].

\(^{477}\) This ‘essential nucleus’ finds textual expression in Section 1 of the Spanish Constitution (sovereignty, social democracy and the rule of law), and the ‘total revision’ procedure in Section 168 (entrenching democracy, the rule of law and fundamental rights), Asepesco (Spain) 706. See, e.g. Fernando; Liñán Nogueras and Roldán Barbero, ‘The Judicial Application of Community Law’ (1993) 30 CMLR 1135, 1142.

\(^{478}\) Castillo de la Torre (2005), 1186.

\(^{479}\) Constitutional Treaty (Spain) [3c] (referring to institutions ‘which exercise powers directly granted by the Constitution … being powers connected with the possession of sovereignty by the Spanish people.’) The Tribunal has
it may review national implementing acts of EU law against the constitution, even if these are of a higher standard than EU law. 480 Like its fellows, the Tribunal respects the ECJ’s jurisdiction as the ‘first line of defence’ of the constitution, but does not abdicate its role as constitutional guardian. 481

A conflict between EU law and the constitution indicates that one is being applied ultra vires. Where this occurs, conflicts between EU law and Spanish law are conflicts of ‘infra-constitutional’ or ‘non-constitutional’ norms, 482 and the status of EU law in the national order ‘is a fact which must be considered as established from the perspective of [national] law.’ 483 It is a problem of ‘the selection of the rule to be applied’ which is ‘a function of the ordinary jurisdiction.' 484 In Constitution for Europe (Spain), the Tribunal held:

‘[T]he constitutional transfer enabled by Section 93 [Spanish constitution] is subject to material limits imposed on the transfer itself. Said material limits […] are understood as the respect for the sovereignty of the State, or our basic constitutional structures and of the system of fundamental principles and values set forth in our Constitution, among which fundamental rights are of particular importance.’ 485

In the United Kingdom, where there is no written constitution, constitutional identity may be assimilated to parliamentary sovereignty. 486 As stated by Laws LJ in Thoburn v Sunderland (UK):

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480 Asepeco (Spain), 706; Constitutional Treaty (Spain) [4]. See: Castillo de la Torre (2005), 1186.
481 Electoral Law (Spain); Asepeco (Spain), 705. Changed to ‘non-constitutional norms’ in FOGASA (Spain).
482 Canary Islands Customs (Spain), 697.
483 Electoral Law (Spain) [5].
484 Constitutional Treaty (Spain) [3] and [4]: ‘The fact that the Constitution is the supreme regulation of Spanish legislation is a matter which, even when it is not expressly proclaimed under whatsoever precept, undoubtedly results from the principle of many of them… In the unlikely case where, in the ulterior dynamics of [the EU], said law is considered irreconcilable with the Spanish Constitution… in a final instance, the conservation of the sovereignty of the Spanish people and the given supremacy of the Constitution could lead this Court to approach the problems which, in such a case, would arise.’ Confirmed recently in Melloni (Spain) (unofficial translation) [3].
485 Parliamentary sovereignty functions as a constitutional ‘lock’ on the abdication of sovereignty redolent of those found in this section: Craig, ‘Constitutional Doctrine within the United Kingdom’ (1998). This was confirmed by Section 18 of the European Union Act 2011, which states: ‘Directly applicable or directly effective EU law … falls to be recognised and available in law in the United Kingdom only by virtue of that Act or where it is required to be recognised and available in law by virtue of any other Act.’ On parliamentary sovereignty, see: AV Dicey, Introduction to the Study of the Law of the Constitution (8th edn, MacMillan 1915; Liberty Fund 1982). For an analysis of the interaction of parliamentary sovereignty and EU supremacy, see: Paul Craig, 'United Kingdom Sovereignty after Factortame' (1991) 11 YBEL 221; Paul Craig and Gráinne de Búrca, EU Law: Text, Cases and materials (5th edn, Oxford University Press
‘There is nothing … which allows the [ECJ] or any other institutions of the EU, to touch or qualify the conditions of Parliament’s legislative supremacy in the United Kingdom. Not because the legislature chose not to allow it; because by our law it could not allow it. …The British Parliament has not the authority to authorise any such thing … it cannot abandon its sovereignty.’

This was confirmed in 2017 in *R (Miller v Secretary of State for Exiting the European Union)*:

“However, legislation which alters the domestic constitutional status of EU institutions or of EU law is not constrained by the need to be consistent with EU law. In the case of such legislation, there is no question of EU law having primacy, so that such legislation will have domestic effect even if it infringes EU law (and that would be true whether or not the 1972 Act remained in force). That is because of the principle of Parliamentary sovereignty which is, as explained above, fundamental to the United Kingdom’s constitutional arrangements, and EU law can only enjoy a status in domestic law which that principle allows.”

In Greece, the constitution contains both an ‘eternity’ clause (Article 28(3)) and a constitutional safeguard clause (Article 110(2)) which place Greece’s status as a Parliamentary Republic, the powers of the state, and basic civil and political rights beyond the reach of the amending power. The Council of State accepts the supremacy of EU law within its competences, but these constitutional values remain outside the EU order, and the court retains exclusive jurisdiction to resolve conflicts with these provisions. In *Karella (Greece)*, the court held that ‘the primacy of the EEC Treaty [is] subject to certain conditions for the possibility of conferring … those powers provided for in the Constitution’, and in *D.I.KATSA (Greece)* the court resolved a conflict with EU law in favour of the constitution, concluding that it was ‘clearly necessary for the preservation of the national identity.’

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487 Thoburn v Sunderland CC (UK) [69].

488 *R (Miller v Secretary of State for Exiting the European Union* [2016] EWHC 2768 (Admin); [2017] UKSC 5, at [67].

489 Constitution of Greece, Art 28(3) permits limitations on sovereignty ‘insofar as this … does not infringe upon the rights of man and the foundations of democratic government and is effected on the basis of the principles of equality and under the condition of reciprocity.’ See: Grabenwarter (2011), 101

490 These are: the division of institutional powers of the state (Art 26), protection for the value of the human being (Art 2), equality before the law and individual social rights (Art 4), individual liberties (Art 5), and religious freedom (Art 13).

491 *Banana Market (Greece)* (Case No 815/1984) in Oppenheimer, The Cases (Vol I) 576 (Greek Council of State)), 578; *Mineral Rights Discrimination (Greece)* (Case No 2152/1986) in Oppenheimer, The Cases (Vol I) 581 (Greek Council of State), 583; *Karella v Minister of Industry (Greece)*, 586 (‘All these provisions [in the Act of Accession] … take precedence over any contrary Greek legislative provision pursuant to Art 28 of the Constitution.’).

492 *Karella v Minister of Industry (Greece)*, 586. See also: *Real Property Acquisition (Greece)*, 589.

493 *Karella v Minister of Industry (Greece)*, 586

494 *D.I.KATSA (Greece)* 300-304.
In Denmark, the Højesteret has never acquiesced in the sovereignty claims of European monism, and the normative supremacy of EU law is not accepted over any provisions of the constitution. There is no constitutional basis for the application of EU law outside the act of accession, and the act of accession is enacted subject to the normative constraints of constitutional law. Section 20 of the Constitutional Act of Denmark only allows for the ‘delegation of powers’ to such extent ‘as shall be provided by statute,’ by five-sixths majority in the Folketing or referendum. The Højesteret has held since Carlsten (Denmark) that ‘no transfer of powers can take place to such an extent that Denmark can no longer be considered an independent state’ or otherwise undermine the ‘democratic system of government.’ In Hausgaard (Denmark), the court ruled that participation in the Union would become unconstitutional if it were to evolve beyond the basis of accession under Section 20 - namely a cooperation of ‘independent, mutually obliged states functioning on the basis of delegated powers’ - since this would violate the Danish identity as an ‘independent state.’ Like its fellows, the Danish courts explicitly reject the contention that EU supremacy ousts the ‘Danish court’s testing of the constitutionality of Acts and EU Acts.’

The constitution of Ireland establishes a ‘sovereign, independent democratic state’, founded upon natural law principles of popular sovereignty. In Crotty (Ireland), the court held that the power to

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496 This is explicit in the Danish Constitution, s 20(2), which states that, ‘if a majority of Parliament so wishes, a treaty adopted in accordance with Section 20 can be revoked.’ See Hausgaard (Denmark) [32]: '[T]he [EU] is still an organisation consisting of independent, mutually obliged States functioning based on powers delegated by each Member State.’

497 As Koch observes, the doctrine of EU supremacy was known and recognised during the parliamentary debates leading to the first accession bill, ‘but it was not - and could not be-stated in the law.’ Koch (2001), 112. However, as there are no limits to constitutional amendment, the Højesteret accepts that ‘the determination of the limits for this must rely almost exclusively on considerations of a political nature.’ Carlsten (Denmark) [35]-[36]. Krunke (2014), 564.


499 Section 20: ‘Powers vested in the authorities of the Realm under this Constitutional Act may, to such an extent as shall be provided by statute, be delegated to international authorities set up by mutual agreement with other states for the promotion of international rules of law and cooperation.’ Section 19 further allows Denmark to participate in international treaties that do not require limitations of sovereignty: see, Hausgaard (Denmark) [12]-[15]. On these provisions, see: Koch (2001), 110, ‘delegate’ connotes the transferring of powers ‘from a superior to an inferior’ system.

500 The principle of sovereignty would be violated if Parliament could no longer legislate freely, or if its powers could be disposed of without democratic consent. Carlsten (Denmark) [35]-[36]. For an excellent discussion of the jurisprudence and public law principle underlying this decision, see: Krunke (2014), 556-558.

501 Hausgaard (Denmark) [32].

502 Hausgaard (Denmark) [42], [46]: ‘If an Act or a judicial decision … raises doubts as to whether it … lies beyond the surrender of sovereignty according to the Accession Act … this may be subject to judicial review.’

503 Art 5 of the Constitution of Ireland established Ireland ‘as a sovereign, independent, democratic state.’ Art 6.1 states: ‘All powers of government, legislative, executive and judicial, derive, under God, from the people, whose right it is to designate the rulers of the State and, in final appeal, to decide all questions of national policy, according to the requirements of the common good. Art 6.2 states: ‘These powers of government are exercisable only by or on the authority of the organs of State established by this Constitution.’ See: Gerard Hogan and Gerry Whyte, JM Kelly: The Irish Constitution (4th edn, Totell Publishing 2003); David Gwynn Morgan, 'The Constitution and the Financial Crisis in Ireland' in Xenophon Contiades (ed), Constitutions in the Global Financial Crisis (Ashgate Publishing 2013) 63.
confer powers on the EU under Article 29.4.6 did not bestow a power on state institutions to dispose of their own competences.\textsuperscript{504} As Cahill concludes, the Supreme Court will ‘defend the Irish constitutional legal order on almost exactly the same terms as the constitutional courts in other Member States.’\textsuperscript{505} This was made clear in Grogan (Ireland), in which the Irish court, like the Corte costituzionale and the BVerfGE before it, explicitly rejected the normative supremacy of EU law over fundamental constitutional guarantees.\textsuperscript{506}

In the Czech Republic, constitutional identity derives from an ‘eternity clause’ which shields the inviolability of the democratic rule of law and the principles of the democratic state from amendment.\textsuperscript{507} In the very first decision of the Ústavní Soud, Lawlessness of the Communist Regime (1993) it was held that these principles are beyond the reach of the legislator,\textsuperscript{508} and the court has carried on to assert this ‘untouchable material core’ in the context of the EU since Sugar Quotas III.\textsuperscript{509} In that case, citing Solange (Germany) and Frontini (Italy), the court emphasised that ‘the essential attributes of a democratic state governed by the rule of law … remain beyond the reach of the Constituent Assembly itself.’\textsuperscript{510} In defining the contours of this jurisdiction, the court has listed sovereignty, the unitary democratic state governed by the rule of law, and the rights and freedoms of man under Articles 1 and 9 of the Czech Constitution;\textsuperscript{511} as well as the protection of minorities, non-discrimination, political pluralism and legal certainty - which it will not interpret to a lower standard than the Constitution.\textsuperscript{512} The court is committed to considering ECJ interpretations, however

\begin{itemize}
    \item Phelan (1997), 57 so puts it, the sovereignty of the Irish people, including the ‘possibility of unilateral denouncement and withdrawal’ forms ‘the limit on amendment to incorporate [EU] law’s claims.’\textsuperscript{504}
    \item Crotty (Ireland), 783: ‘If it is now desired to qualify, curtail or inhibit the existing sovereign power… it is not within the power of the Government itself to do so.’ See also: Collins (Ireland) [95]-[98].
    \item Cahill (2011), 95.
    \item SPUC v Grogan I (Irish Supreme Court), 765, per Finlay CJ (Hederman and Griff JJ concurring): ‘In the instant case where the right sought to be protected is that of a life, there can be no question of a possible or putative right which might exist in European law as a corollary to a right to travel so as to avail of services… That constitutionally guaranteed right must be fully and effectively protected by the courts.’ All three decisions in Grogan I stated that the Irish court had exclusive competences to adjudicate on fundamental constitutional guarantees. See, at 765 per Finlay CJ (Hederman J concurring) and 770 per Walsh J.
    \item Art 9 of Czech Constitution reads: ‘(1) The Constitution may be supplemented or changed only by constitutional law. (2) The substantive requisites of the democratic rule of law is inadmissible. (3) Interpretation of legal rules may not authorise the removal or endanger the foundations of a democratic state.’
    \item Lawlessness of the Communist Regime (Czech Republic). This was extended to fundamental human rights in Bankruptcy Trustee (Czech Republic) Pl US 36/01 (25 June 2002) available at: <http://wwwnalususoudcz> accessed 12 July 2016 (Ústavní Soud): ‘No amendment to the Constitution may be interpreted in a sense, in consequence of which the already achieved procedural level for the protection of fundamental rights and basic freedoms would be restricted.’
    \item Sugar Quotas III (Czech Republic) [A-3B]
    \item Sugar Quotas III (Czech Republic) [A-3B]: ‘The delegation of a part of the powers of national organs may persist only so long as these powers are exercised in a manner that is compatible with the foundations of state sovereignty.’
    \item Lisbon I (Czech Republic) [91], [93]: ‘These principles cannot be touched even by an amendment to the Constitution implemented formally in harmony with law…’). See also: Lisbon II (Czech Republic) [111]-[113] (though refusing to catalogue a list of such powers, the court pledged to consider protection on a case by case basis).
    \item Bankruptcy Trustee (Czech Republic); Sugar Quotas III (Czech Republic) [40]; Lisbon I (Czech Republic) [109], [208].
\end{itemize}
conflicts are to be resolved by the Czech court,\textsuperscript{513} and it has, in fact, struck down EU law under its identity jurisdiction (including a decision of the ECJ).\textsuperscript{514}

In \textit{Poland}, the \textit{Tribunal Konstytucyjny} has asserted both an \textit{ultra vires} jurisdiction as well as an ‘untouchable material core’ inherent in the Polish constitutional identity.\textsuperscript{515} In \textit{Lisbon I (Poland)}, the \textit{Tribunal} demarcated this jurisdiction as follows:

‘The Constitutional Tribunal shares the view expressed in the doctrine that the competences, under the prohibition of conferral, manifest about a constitutional identity … the following should be included among the matters under the complete prohibition of conferral: decisions specifying the fundamental principles of the Constitution and decisions concerning the rights of the individual which determine the identity of the state, including, in particular …. human dignity and constitutional rights… statehood… democratic governance… the rule [of] law… social justice… subsidiarity… and the prohibition to confer the power to amend the Constitution and the competence to determine competences.’\textsuperscript{516}

In \textit{Estonia}, the Constitution Amendment Act contains a constitutional safeguard clause which allows membership in the Union ‘provided the fundamental principles of the [Constitution] are respected.’\textsuperscript{517} In \textit{ESM (Estonia)}, the \textit{Riijikohus} affirmed that this ‘does not authorise the integration process of the [EU] to be legitimised or the competence of Estonia to be delegated to the [EU] to an unlimited extent’\textsuperscript{518}

\textsuperscript{513} \textit{Sugar Quotas III (Czech Republic)} [A-3B].

\textsuperscript{514} \textit{Sugar Quotas III (CZ)} (implementation of the sugar directive a violation of non-retroactivity); \textit{Slovak Pensions XVII (Czech Republic)} (ECJ decision in \textit{Landtová v Česká} is in violation of the constitutional identity).

\textsuperscript{515} The constitutional identity of Poland is implied from the ‘sole existence of the Constitution’ itself. In particular, Art 2 of the Polish Constitution ‘The Republic of Poland shall be a democratic state ruled by law and implementing the principles of social justice’ and Art 90 of the Constitution (the competence to confer competences). See: \textit{Accession Treaty (Poland)} [1], [2.1] at 202 (the Constitution not ‘authorise the delegation of competences to such an extent that it would signify the inability of the Republic of Poland to continue functioning as a sovereign and democratic state.’); \textit{Lisbon (Poland)}, grounds 2.1, 2.2 et seq (‘The principle of protection of the state’s sovereignty… requires respecting… the constitutional limits of conferral of competences … the deciding powers [of which] are vested in the relevant authorities of the Republic of Poland… an interpretation of the Treaty provisions aimed at undermining the state’s sovereignty or endangering national identity, and at taking over sovereignty - in a non-contractual manner - within the scope of competences which have not been conferred, would be inconsistent with the Treaty of Lisbon.’); \textit{Representation of Poland in the European Council} Judgment of 20 May 2009 - Kpt 2/08 in Biblioteka Trybunału Konstytucyjnego, \textit{Selected Rulings} (Vol LI) 122 (Trybunal Konstytucyjny), ground 5.8; \textit{Brussels Regulation (Poland)}, grounds 1.5, 2.2 et seq; \textit{ESM & TSCG (Poland)}, grounds 3.2, 6.3.1 (The guarantee of preserving the constitutional identity of the Republic is Article 90 of the Constitution and the boundaries of conferral of competences set therein’). See also: Grabenwarter (2011), 99.

\textsuperscript{516} \textit{Lisbon (Poland)}, 202-203. See also: \textit{ESM & TSCG (Poland)} [6.4.1].

\textsuperscript{517} The Constitution of the Republic of Estonia Amendment Act RT I 2003, 64, 429 contains a constitutional safeguard clause, which allows membership in the Union ‘provided the fundamental principles of the [Constitution] are respected.’ See: \textit{Interpretation of the Constitution (Estonia)}, per Kergandberg J and Kõve J.

\textsuperscript{518} \textit{ESM (Estonia)} [222]. See also: \textit{Interpretation of the Constitution (Estonia)}, per Kergandberg J and Kõve J. Significantly, in \textit{Hadleri Toidulisandite AS} (Case No 3-3-1-33-06) of 5 October 2006 (Supreme Court Administrative Chamber), the \textit{Riijikohus} appeared to adopt a parallel interpretation of EU law when it invalidated a national implementing measure in conflict with the constitution by invalidating it as incompatible with EU law (as opposed to the Constitution, with which it was also in conflict). Rather than interpret the constitution in line with EU law, as required to do under \textit{Simmenthal} the \textit{Riijikohus} interpreted EU law in line with the constitution.

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In Latvia, the Satversmes tiesa has held since Re Lisbon (Latvia) that ‘National identity of the Member States is an essential basis of the EU that, being enshrined in treaties, causes legal consequences.’ 519 In Re Lisbon (Latvia) the constitutional identity jurisdiction was enunciated as follows:

‘Consequently, delegation of competencies cannot exceed the rule of law and the basis of an independent, sovereign and democratic republic based on the basic rights. Likewise, it cannot influence the right of citizens to decide upon the issues that are substantial for a democratic state… the Satversme does not provide for an unlimited delegation of competencies, which would prohibit considering Latvia as a sovereign State.’

In Sweden, Chapter 10§5 of the Instrument of Government stipulates that the conferral of powers on the Union must ‘not affect the principles of the form of government’ and is presupposed on an equivalent level of fundamental rights protection. 521 The transfer of Kompetenz-kompetenz or decision-making concerning the fundamental principles of the Instrument of Government is prohibited. 522 Furthermore, as accession is done by an act of parliament, it is ‘seen as quite clear’ that this implicitly precludes delegation in areas such as ‘the electoral system and similar matters.’ 523 This position was confirmed upon accession in a unanimous Opinion by the Committee for Constitutional Affairs, which listed a number of ‘fundamental principles of our constitutional system’ and declared that ‘the limit for this instrument of government is the basis for the Swedish state condition.’ 524 The Högsta Domstolen has not openly challenged EU law on this basis, however it has in fact defended those reserves by, for example, treating conflicts with EU law as issues of purely national law and refusing to submit a preliminary reference, even though this would appear prima facie contrary to EU law. 525

519 Re Lisbon (Latvia), 54, 58. Latvian constitutional identity finds textual expression in the principles entrenched by referendum under Article 77 of the Constitution of Latvia, consisting of consisting of the independent democratic republic (Art 1); popular sovereignty (Art 2); territorial integrity (Art 3); and language (Art 4). With regards to democratic sovereignty, in Re Lisbon (Latvia), 46 and 54, the court emphasised that what is decisive is the supremacy of the Constitution and the sovereignty of the people – in essence, control over the Kompetenz-kompetenz: ‘the Satversme does not provide for an unlimited delegation of competencies, which would prohibit considering Latvia as a sovereign State.’

520 Re Lisbon (Latvia), 54, 58: ‘the State of Latvia is based on such fundamental values that, among the rest, include basic rights and fundamental freedoms, democracy, sovereignty of the State and people, separation of powers and rule of law.’ (Ratification of Treaties under which the EU could transmute into a state would violate the Latvian constitutional identity.)

521 The Instrument of Government (Rikstag, 2015), ch 10, s 5 reads: ‘The Riksdag may transfer a right of decision-making which does not affect the principles of the form of government within the framework of European Union cooperation. Such transfer presupposes that protection for rights and freedoms in the field of cooperation to which the transfer relates corresponds to that afforded under this Instrument of Government and the [ECHR].’

522 Instrument of Government of Sweden, ch 10, s 5(2) reads: ‘No right of decision- making relating to matters concerning the enactment, amendment or abrogation of fundamental law, the Riksdag Act or a law on elections for the Riksdag, or relating to the restriction of any of the rights and freedoms referred to in Chapter 2 may be thus transferred.’

523 Lebeck, 13. See also Griller (2001), 173: ‘This implies a serious reservation against the principle of supremacy.’

524 This included open government, freedom of information, the prohibition of censorship, protection of whistle-blowers, the accountability system, and freedom of speech: Konstitutionsutskottet, (1993), 27.

525 In AAA v Strix (Sweden). See also: Agricultural documents (Sweden) (Case No 71690/04) judgment of 23 November 2005; RÅ 2005 ref 87 available at: <https://lagennu/dom/ra/2005:87> accessed 4 July 2016 (Supreme Administrative
**Austria** is not considered to retain constitutional reserves of powers that can never be conferred on the Union, however amendments to the fundamental principles of the Constitution must be passed by the ‘total revision’ (Gesamtänderung) procedure under Article 44(3) of the Constitution, and it is by this procedure that the Act of Accession was enacted. The current Act of Accession does not take priority over the fundamental principles of the Constitution and, according to the Government upon accession, ‘the fixed core of Austrian constitutional law cannot be changed by Community law nor indeed be required to be interpreted in the light of [EU] law.’ The ruling of the VfGH in *ESM (Austria)*, for example, appears to indicate that an open-ended conferral of budgetary policy would be unconstitutional without the Gesamtänderung procedure.

In **Lithuania**, the constitutional authorisation for the application of EU law derives from the Constitutional Act on Membership (Lithuania), which explicitly states that EU law may be supreme over ordinary law, but not constitutional law. There is no basis for the constitutional supremacy of EU law, and the *Konstitucinis Teismas* holds that the principle of the independent democratic state entails the supremacy of the whole constitution - not just fundamental guarantees. This position

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526 The memorandum to the Act of Accession refers to the limits in the German *Maastricht* decision, but makes clear that it guarantees the opening up of the Austrian legal system to the *acquis*, including direct effect and supremacy. Grabenwarter (2011) 85, 101; Griller (2001) 149; Foster (2003) 144; Nigel Foster, Foster on EU Law (4th edn, Oxford University Press 2013), 153; Claudia Mayer, ‘ESM Treaty in accordance with the Austrian constitution’ (2013) 7 ICLJ 385.

527 The fundamental principles consist of: democracy, the rule of law, the separation of powers, fundamental rights and freedoms, and the federal and republican state. A total revision requires not only a two-thirds majority in Parliament (the ordinary revision procedure), but also a positive vote in a referendum. Austrian Federal Constitutional, art 44(3).


529 As translated in: Foster, *Austrian Legal System & Laws* (2003), 144. The original authorisation is ‘deliberately narrow,’ covering only the Treaty of Accession, but ‘does not cover later amendments of the EU legal order: Griller (2001), 149.

530 In *ESM (Austria)* the VfGH upheld the ratification of the ESM Treaty under Art 9(2) as being sufficiently ‘specific and limited’ because it provided for a capped amount of financial contribution. *A contrario*, it means that such an open-ended commitment would be unconstitutional. See, e.g., Mayer (2013), 399.’What is yet to be answered is whether and where constitutional law sets limits for authorisations to the executive or international organisations regarding measures with implications for the budget.’

531 Act on Membership of the Republic of Lithuania in the EU (Lithuania), art 2: ‘The norms of European Union law shall be a constituent part of the legal system of the Republic of Lithuania. Where it concerns the founding Treaties of the European Union, the norms of European Union law shall be applied directly, while in the event of the collision of legal norms, they shall have supremacy over the laws and other legal acts of the Republic of Lithuania.’


533 ‘A fundamental requirement for a democratic state under the rule of law is the principle of the supremacy of the Constitution … where it is prescribed that any law or any other act contrary to the Constitution is invalid.’ *Referendums (Lithuania)* [2.4]. See also: *On limitation of rights of ownership (Lithuania)* [9.4] ‘n the event of collision of legal norms, they shall have supremacy over the laws and other legal acts of the Republic of Lithuania … save the Constitution itself.’
has been maintained consistently by the Konstitucinis Teismas.\textsuperscript{534} The Konstitucinis Teismas accepts the ordinary supremacy, direct effect and indirect of EU law,\textsuperscript{535} but emphasises that the purpose of the Constitutional Court ‘is to guarantee the supremacy of the constitution in the legal system as well as constitutional legality.’\textsuperscript{536}

In Hungary, participation in the EU is governed by Article E (ex 2/A) of the Fundamental Law which speaks of the ‘joint exercise’ of ‘some of its competences’ when ratified by a qualified majority in the Parliament.\textsuperscript{537} As Article E was introduced as part of controversial amendments to the constitution in 2013, there are not yet any constitutional decisions on this provision, and the Magyarország Alkotmánybirósága may no longer refer to its pre-2011 case law.\textsuperscript{538} The position is therefore unclear. In previous case law, however, the Magyarország Alkotmánybirósága held that this ‘European clause’ (ex Article 2/A) could not be interpreted in such a way that would ‘deprive the sovereignty and rule of law of their substance.’\textsuperscript{539} In Agricultural Surplus Stocks (Hungary) and Lisbon (Hungary), because Article 2/A only allowed for constitutional powers to be exercised by EU institutions, this was considered to contain a nemo plus iuris rule that prevents Hungary from conferring its competences on the EU unless the Union respects Hungarian constitutional guarantees.\textsuperscript{540}

\textsuperscript{534} Status of the national broadcaster (Lithuania) [IV], [1.1]; Elections to the European Parliament (Lithuania) [III]; Referendums (Lithuania) [3.3.1]; On the financial stability of banks (Lithuania).

\textsuperscript{535} Applying to the CJEU (Lithuania) [II].

\textsuperscript{536} Applying to the CJEU (Lithuania) [I], 1.

\textsuperscript{537} The Constitution of Hungary, art E reads: ‘(2) With a view to participating in the European Union as a Member State and on the basis of an international treaty, Hungary may, to the extent necessary to exercise the rights and fulfil the obligations deriving from the Founding Treaties, exercise some of its competences set out in the Fundamental Law jointly with other Member States, through the institutions of the European Union. (3) The law of the European Union may, within the framework set out in Paragraph (2), stipulate generally binding rules of conduct.’ Article 24 then bestows supremacy of international treaties over conflicting statutes.

\textsuperscript{538} Where the former Article 2/A of the 1949 constitution spoke of the exercise of ‘certain’ powers (which is typically interpreted as meaning specific and limited powers) Article E/2 now speaks of the less predetermine ‘some’ powers. However, this is counterbalanced by the introduction of Article E(3), which both establishes the supremacy of EU law and confines it ‘within the framework set out in Paragraph (2),’ which is the Treaties ratified by qualified majority. For comment: Grabenwarter (2011), 100.

\textsuperscript{539} Lisbon (Hungary) [IV.2.(3). In Europe Agreement (Hungary), the court held that ‘it is a constitutional requirement based on the principles of popular sovereignty and the democratic rule of law that in the Hungarian Republic, public authority may only be exercised on the basis of democratic legitimacy.’ See: Allan F Tatham, ‘Constitutional Judiciary in Central Europe and the Europe Agreement: Decision 30/1998 (VI.25) of the Hungarian Constitutional Court’ (1999) 48 ICLQ 913; Renata Uitz, ‘EU Law and the Hungarian Constitutional Court: lessons of the First Post-accession Encounter’ in Wojciech Sadurski, Jacques Ziller and Karolina Zurek (eds), Après Enlargement: Legal and Political Responses in Central and Eastern Europe (Robert Schuman Centre 2006) 41.

\textsuperscript{540} In Lisbon (Hungary) the Court made explicit reference to Brunner (Germany) and ruled that if the Lisbon Treaty entered into force, ‘this did not mean that the Act of promulgation had to be treated in a different way as compared to the review of ordinary acts and other legal norms which might be challenged according to the actio popularis system.’ In Agricultural Surplus Stocks (Hungary) at [IV.1], [IV.4], the court invalidated several provisions of a national implementing act as unconstitutional on grounds of retroactivity. Commentators have emphasised that the law struck down was ‘identical do the transitional measures adopted in the Commission Regulations.’ Sadurski (2014), 10. See also: Uitz (2006).
In **Finland**, Section 94(3) of the Constitution states: ‘An international obligation shall not endanger the democratic foundations of the Constitution.’\(^{541}\) This is widely interpreted as an attempt to emulate a substantive constitutional reserve redolent of the Danish, Swedish, Greek and German constitutional safeguard clauses.\(^{542}\) Although Finland has no constitutional court, it was applied by the *Perustuslakivaliokunnan ex-ante* to evaluate the act of conferral at Lisbon, and to examine the effect of the TESM on budgetary sovereignty in 2012.\(^{543}\)

The point to be extracted from this survey is that the ‘constitutional’ identity jurisdiction and the (EU) ‘national’ identity review occur in entirely separate constitutional orders. In Germany, the Czech Republic, Greece, Spain, Austria and Lithuania, the limit is inscribed in the constitution as part of an unamendable ‘eternity clause’ or a ‘total revision’ procedure. In Sweden, Finland, Portugal, Denmark, and Estonia the limit is inscribed in a constitutional safeguard clause which subjugates the act of conferral to specified ring-fenced values. In Italy, France, the UK, Ireland, Poland, Hungary and Latvia, the constitutional identity is implied from the constitutional structure of the state itself. Article 4(2) TEU does not touch the constitutional basis for identity review, and the ECJ has no competence to interpret national constitutions.

For Member State constitutional courts, 4(2) TEU is merely ratificatory of ‘the thrust of the jurisprudence of numerous domestic constitutional courts on the relationship between EU law and national constitutional law.’\(^{544}\) The *Tribunal Constitucional*, for example, has stated that ‘the limits referred to by the reservations of said constitutional justifications now appear proclaimed unmistakably by the Treaty.’\(^{545}\) The BVerfGE also describes Article 4(2) TEU as merely parallel and ratificatory.\(^{546}\)

This is so because scope and content of the constitutional identity involves the interpretation of constitutional law, and the CJEU lacks jurisdiction to do so under Article 19 TFEU.\(^{547}\) As a matter of

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\(^{541}\) In practice, the Constitution Committee did not focus on this provision in reviews of the Lisbon and ESM Treaties, though this is perhaps explained that the constitutional reserve is essentially comprised of democracy, which is safeguarded by the dualist system itself. See: *Opinion 13/2012 on the ESM (Finland)*. See also: *Opinion on the approval of the Treaty of Lisbon (Finland)* (PeVL 13/2008 vp) available at: <www.eduskunta.fi> accessed 1 June 2016 *Perustuslakivaliokunnan* (Constitution Committee). For comment, see: Griller (2001), 166-168.


\(^{543}\) *Opinion on Lisbon (Finland)* (proposing more specific empowerment provisions for the conferral of powers on EU law in the body of the constitution); and *Opinion 13/2012 on the ESM (Finland)* (confirming that the ESM did not raise issue of budgetary sovereignty, since contributions were capped). For comment, see: Griller (2001), 166-168 and committee decisions cited (discussing participation in the Exchange Rate Mechanism).

\(^{544}\) von Bogdandy and Schill (2011), 1419. The *Trybunal Konstytucyjny*, for example considers ‘the concept of national identity’ under primary EU law to be ‘an equivalent to of the concept of constitutional identity.’ *Lisbon (Poland)*, 203

\(^{545}\) *Constitutional Treaty (Spain)* [3].

\(^{546}\) *Re Lisbon (Germany)* [216]-[217] ‘The exercise of this [constitutional identity] review power, is rooted in constitutional law … the fundamental political constitutional structures of sovereignty Member States, which are recognized by art.4.2 TEU cannot be safeguarded in any other way.’

law, it is blind to the ‘identities’ which it professes to define respect for.\textsuperscript{548} Indeed, the ECJ has itself accepted (though not always)\textsuperscript{549} that only the national courts can define what is and is not part of the national identity.\textsuperscript{550} Nonetheless, it cannot be avoided: when deciding the weight of such claims under proportionality, the ECJ still enter into a forbidden zone of determining the content and scope of the constitutional identity of a Member State. This is in essence contrary to Article 19 TFEU and also contrary to its duty to respect Article 4(2) TFEU.\textsuperscript{551}

In sum, the Article 4(2) TFEU jurisdiction does not provide an authoritatively descriptive of the limits of the constitutional identity jurisdiction for the purposes of this thesis. For the Member States, ‘constitutional identity’ is not a matter for EU law at all: Member States have no power to give it, so the EU must not have it.\textsuperscript{552}

\subsection*{1.2.2.2 Normative Evaluation of Constitutional Identity Review}

The purpose of this section is to show that Member State ‘constitutional identities’ and EU ‘national identity’ have different normative content, and that the ECJ’s interpretation of the former as EU norms appears to make little sense to constitutional courts. Member State constitutional courts do not weigh EU law and constitutional identity in accordance with the normative weight the ECJ ascribes to them. Member State courts continue to weigh these norms according to their content. In that regard, although the contours of the Member State constitutional identities in this chapter are

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\textsuperscript{548} Under Art 24, Statute of the CJEU, however: ‘The Court may also require the Member States and institutions, bodies, offices and agencies not being parties to the case to supply all information which the Court considers necessary for the proceedings.’

\textsuperscript{549} Case C-393/10 O’Brien v Ministry of Justice (Second Chamber, 1 March 2012) [49] (rejecting a claim by the Latvian government that Directive 97/81 does not respect Art 4(2) TFEU and holding that the directive ‘cannot have any effect on national identity.’); Case C-58/13 Torresi v Avvocati di Macerata (Grand Chamber, 17 July 2014) [58]; Melloni (Opinion of AG Bot) [140]-[141] (on the basis of statements by the government, holding that the case fell within an exception to the Spanish constitutional identity – which the EU has no competence to do).

\textsuperscript{550} Omega [30] (the legitimate interest pursued does not have to correspond to a conception shared by all member States); Case C-53/04 Marrosu and Sardino v Azieda ospudaliera Ospedale [2006] ECR I-7213 (Opinion of AG Maduro) [40] (‘[national] authorities are best placed to define the constitutional identity of the Member States which the [EU] has undertaken to respect’); Joined Cases C-428-434/06 UGT-Rioja v Territorio Histórico de Vizcaya [2008] ECR I-6747 (Opinion of AG Kokott) [54] (‘The Union cannot encroach the constitutional order of a Member State … and does not in principle have any influence on the division of competences within a Member States.’); Michaniki (Opinion of AG Maduro) [32]; Case C-222/07 UTECA v Administración General del Estado [2009] ECR I-1407 (Opinion of AG Kokott) [100]; Case C-135/08 Rottman v Freistaat Bayern (Opinion of AG Maduro, 30 September 2009) [25].

\textsuperscript{551} Preshova (2012). See also: von Bogdandy and Schill (2011), 1448, ‘The ECJ’s … cannot determine the content of a Member States’ national identity itself… Otherwise, the ECJ would overstep its jurisdictional mandate in Article 19(1) TFEU, which limits the Court’s jurisdiction to the interpretation of EU law.

\textsuperscript{552} Re Lisbon (Germany) [319] (EU powers are given by national acts, which can only be given within the limits of the current constitutional order).
heterogeneous in terms of their specificity and entrenchment, they nonetheless share a ‘remarkable convergence’ on two core normative principles: Constitutional Democracy, sometimes defined as popular sovereignty, is the basis of all twenty-seven Member State constitutions. In all nineteen constitutional identity jurisdictions, this principle requires that no state institution may validate an exercise of public power that is not democratically legitimated in the manner specified in the constitution. All, including the most basic among them, preclude a disposition of the Kompetenz-kompetenz. The most developed, such as the German ‘eternity’ clause, entrench a specific formula for democracy: they require, in essence, that x powers can only be exercised by y institutions according to z formula, and these components themselves are not amendable.

The rule of law, sometimes listed as human dignity or fundamental rights, requires constitutional courts to guarantee a degree of rights protection at least equivalent to national constitutional law.

That these two principles can be essentially encapsulated as the definition of constitutional democracy is perhaps not surprising. And yet, the tension that arises with EU supremacy whenever the ECJ interprets ‘national identity’ as having a different meaning than that ascribed under constitutional law seem to be a continuous source of surprise for Europe’s jurists. Indeed, some scholars have poured scorn on the notion that the shape of the Union’s competences is constrained by the shape of national constitutional identities. Under Article 4(2) TEU, there is no recognition of inalienable constitutional reserves of sovereignty outside the legal order which can be invoked against the expansion of EU law. The ECJ has interpreted ‘national identity’ as an open-ended list

553 This is even recognised under the CJEU’s review jurisdiction. See: Michaniki (Opinion of AG Maduro) [33] (‘the fact that the view of the fundamental right held … is not shared by other Member States does not prevent that member State from relying on it so as to justify a restriction of the freedom to provide services.’ See also: Case C-36/02 Omega Spielhallen-und Automatenaufstellungs-GmbH v Bundestadt Bonn [2004] ECR 1-9509 [30]; Case C-205/09 Umweltanwalt von Kärnten v Kärntner Landesregierung [2009] ECR 1-11525 [47].

554 Identifying these same common denominators: von Bogdandy and Schill (2011), 1432.

555 See: Section 1.2.1.

556 Common components of the rule of law which appear across jurisdictions include, inter alia, human dignity (UN Convention (Italy) [3.4]; Solange II (Germany) [339], [381]; Brunner (Germany), 187), non-retroactivity (Agricultural Surplus Stocks (Hungary) [IV.1]; Riga Land Use Plan (Latvia) (Case 2007-22-03 of 17 January 2008 (English version available at: <http://wwwsvatiesgolv> accessed 17 July 2016.); 60; Sugar Quotas III (Czech Republic)); the right to a fair trial (EAW (Cyprus); EAW (Poland); EAW (2735/14) (Germany)); and effective judicial protection: EAW (2735/14) (Germany); Carlsern (Denmark) [182]; Accession Treaty (Poland); Lisbon I (Czech Republic) [135], [186]; UN Convention (Italy) [3.4] (‘the right to effective judicial protection is ‘one of the supreme principles of our constitutional order, intrinsically connected to the principle of democracy itself’). See also: Case C-50/00 Unión de Pequeños Agricultores v Council [2002] ECR 1-6681 (Opinion of AG Jacobs) [86].

557 See, e.g., Gauweiler II (Opinion of AG Cruz-Villalon) [59]-[60], recited below, at p. 74.

558 Pescatore (1970), 181; Wendel (2014); and Gallagher (2012), 6 (‘The Court’s insistence on this right of ultimate review [is] wholly inconsistent with the EU legal order’).

559 Case 379/87 Groener v Minister for Education [1989] ECR 3967 [18] (Irish language protection for the purpose of national identity falls under public exceptions); Commission v Luxembourg [35] (‘Member States’ national identities is a legitimate aim as indeed acknowledged in Art F(1) of the [TEU]… but] can still be effectively safeguarded otherwise than by a general exclusion…’); Michaniki (Opinion of AG Maduro) [32] (‘a Member State may … assert the protection of its national identity in order to justify a derogation from the application of fundamental freedoms.’).
of cultural, social or legal traits which may be taken into consideration so long as they do not constitute a disproportionate stop on the objective of EU law.\textsuperscript{560} On this reading, Article 4(2) TEU does not brace the containment walls of EU competence – it subsumes them within the European legal order and gives the ECJ a jurisdiction to examine their merit. It is no different than other ‘legitimate aims’ whose purpose is, as stated in Cassis, ‘not to reserve certain matters to the exclusive jurisdiction of the Member States’ but to allow derogations to the extent justified against the objectives of EU law.\textsuperscript{561} Constitutional identity is limited by the objectives of EU law, not the other way around. In Michaniki, the ECJ held:-

‘national constitutional rules can be taken into consideration to the extent that they fall within the discretion available to the Member States … within the limits fixed by the principle and the [instrument of EU legislation] itself.’\textsuperscript{562}

Article 4(2) TEU allows the ECJ to encompass all those principles not common enough to be ‘general principles’ on their own into a single principle of what Lenaerts calls ‘value diversity’ – over which it then has jurisdiction.\textsuperscript{563} In all cases, ‘identity’ claims are assimilated as legitimate aims pursuant to a recognised EU derogation (and then subserviated to EU legislation under the proportionality test);\textsuperscript{564} or they will be assimilated as anyways indistinguishable from EU norms – such as the protection of language or other fundamental values of the Union (and then interpreted in conformity with the EU law iteration).\textsuperscript{565} So, for example, in Melloni, it was accepted that the right to

\textsuperscript{560} See, e.g., Michaniki [63], and Michaniki (Opinion of AG Maduro) [32]-[33]; Vasiliki Kosta, 'Case Comment: Michaniki AE v Ethniko' (2009) 5 EUConst 501.

\textsuperscript{561} Lenaerts, 'How the ECJ Thinks: A Study on Legitimacy' (2013), 1328-1330.

\textsuperscript{562} This approach is visible in Sayn-Wittgenstein [83]-[83], [91]-[92], where the court assimilated Austria’s constitutional status as a republic to reliance on the ‘public policy’ exception and then subjected it to proportionality. Similarly, in Omega, the CJEU recognised the principle of human dignity (part of Germany’s constitutional identity), but assimilated this under the Treaty’s public policy exception. See also: Commission v Luxembourg [35] et seq; Michaniki [61]; Omega [33] et seq; Case C-341/05 Laval un Partneri Ltd. v Svenska Byggnadsarbetareförbundet [2007] ECR I-11767 [87].

\textsuperscript{563} Omega (recognising the principle of human dignity, but holding that this objective fell within the public policy exception); Anton Las (Opinion of AG Jääskinen) [58] (noting that national identity is used ‘not in order to justify national measures constituting barriers in relation to use of languages, but only with a view to understanding the language regime specific to the EU’); Case C-556/10 Italy v Commission (Opinion of AG Kokott, 21 June 2012) [87] (‘The principle of multilingualism is part of the cultural pluralism and national identities of the Member States. It is therefore based on the fundamental values of the European Union.’). Mary Dobbs, 'Sovereignty, Article 4(2) TEU and the Respect of National Identities: Swinging the Balance of Power in Favour of the Member States?' (2014) 33 YEL 320:
a fair trial under the Spanish constitution could constitute national identity, but it was denied that it could be given a stricter interpretation than the Charter.\textsuperscript{566} Similarly, in Laval, Viking Line ABP, and Runevič-Vardyn, ‘identity’ justifications were assimilated to other Treaty provisions (not 4(2) TEU), suggesting that the ECJ views these claims as issues of purely EU law.\textsuperscript{567}

The case for accepting these interpretations is normative argument: If Member States do not accept the constitutional superiority of EU adjudication, then they must accept the normative importance of the ‘uniformity and effectiveness’ of EU law, else the EU legal order will break down.\textsuperscript{568} The danger is what Kumm refers to as the ‘Cassandra scenario’ - to allow Member State constitutional identity review would cast the EU into a state of inter-statal anarchy, threatening over 65 years of peace and cooperation.\textsuperscript{569} Member States would invoke constitutional law to evade legal obligations as frequently as Article 2(7) of the UN Charter, and the Union would become ‘paralyzed by deep antagonisms.’\textsuperscript{570} Some warn of a ‘constitutional cataclysm’ or ‘the assured destruction of the relationship between the two legal orders.’\textsuperscript{571} In Gauweiler v Bundesbank, AG Villalón opined:

‘[I]t seems to me an all impossible task to preserve this Union, as we know it today, if it is to be made subject to an absolute reservation, ill-defined and virtually at the discretion of each of the Member States, which takes the form of a category described as ‘constitutional identity… Such a ‘reservation of identity’, independently formed by the competent - often judicial - bodies of the Member States would very probably leave the EU legal order in a subordinate position.’\textsuperscript{572}

With respect, however, it is difficult to see why this is so, and virtually no national court has accepted this normative claim over constitutional identity.\textsuperscript{573} This is so for two reasons.

First, as the Riijikohus’ Köve J so puts it, ‘absolute’ supremacy would appear to ‘overestimate the theory.’\textsuperscript{574} Participation in this Union as we know it today simply does not entail ‘supranational

this approach means that it is not ‘constitutional law per se trumping EU primary law,’ but legitimate objectives of EU law itself.\textsuperscript{566} Melloni (Opinion of AG Bot) [139]-[142].\textsuperscript{566} Laval [91]-[92], C-438/05 Viking Line ABP [2007] ECR I-10779 [85]-[90], and Runevič-Vardyn (Opinion of AG Jääskinen) [83]-[96].\textsuperscript{568} Costa v ENEL, 594: ‘EU law could not be overridden by domestic legal provisions ‘without the legal basis of the Community itself being called into question.’ See also: Internationale Handelsgesellschaft [3]; Commission v Luxembourg [38]; Gauweiler II (Opinion of AG Cruz-Villalón) [59]-[60].\textsuperscript{570} Kumm refers to this as the Principle of Constitutional Fit: Kumm, 'Final Arbiter' (1999), 375.\textsuperscript{572} Pescatore (1970), 176.\textsuperscript{570} Groussot (2008), 103. See also: LENAERTS, 'Federalism' (1997), 777, ‘if the regulations of the component entities were to prevail’, the uniformity and effectiveness of EU law would be endangered - ‘as would the federation itself.’\textsuperscript{572} Gauweiler II (Opinion of AG Cruz-Villalón) [59]-[60].\textsuperscript{573} See, e.g., EAW (2735/14) (Germany) [1][2](b): ‘A substantial risk to the uniform application of [EU] law does not result.’ Ireland: SPUC v Grogan I (Irish Supreme Court), 765, ‘If and when a decision of the [ECJ] rules that some aspect of [EC] law affects the activities of the defendants impugned in this case, the consequence of that decision on these constitutionally guaranteed rights and their protection by the courts will then fall to be considered by these courts.’ Spain: Constitutional Treaty (Spain) [3]. Germany: Re Lisbon (Germany) [217], ‘the finding of a violation of constitutional identity is incumbent on the Federal Constitutional Court alone.’\textsuperscript{574} Constitutional Treaty (Spain) [3], per Köve J. For the same point: Re Lisbon (Germany) [204], [239].
“access” to the Member States’ legal orders’ outside its competences - particularly when no such authorisation is even possible under many constitutions.\textsuperscript{575} That sort of ‘in for a penny, in for a pound’ argument has been dismissed as both disingenuous and undemocratic. As the Trybunał Konstytucyjny has pointed out, ‘it is impossible in a democratic state rule by law to create presumed competences.’\textsuperscript{576} The BVerfGE agrees: ‘integration into a free community neither requires submission removed form constitutional limitation and control nor the forgoing one’s own identity.’\textsuperscript{577} 

Second, constitutional courts openly doubt the normative superiority of a principle of legal ordering where the only inviolable principle is the effectiveness of executive law.\textsuperscript{578} The ECJ itself is under the duty to ‘respect’ national identities, but has, by most accounts, made a highly controversial job of it.\textsuperscript{579} It has often refused to weigh constitutional identity considerations, even when flagged by AG Opinions,\textsuperscript{580} or the Member States themselves,\textsuperscript{581} and has sometimes dismissed assertions from governments - and even constitutional courts(1) - that something is part of the national identity.\textsuperscript{582} Despite several AG Opinions, Article 4(2) TEU was not cited in a single ECJ decision from its introduction in 1992 until after the rejection of the Constitutional Treaty in 2008.\textsuperscript{583} In the entire

\textsuperscript{575} Germany: Re Lisbon (Germany) [318] and [204], [239]: To cross the threshold ‘to a federal state and to the giving up of national sovereignty would require a free decision of the people in Germany beyond the present applicability of the Basic Law...’ Italy: Frontini (Italy) [21]; Fragd (Italy) [8]. France: Re Maistrich (France); Constitution for Europe (France) [7]. Spain: Constitutional Treaty (Spain) [2]. Portugal: ERDF (Portugal), 687-688. Greece: DL.KATSA (Greece), 300-304. Belgium: European Schools (Belgium) [B.4]. Denmark: Carlsen (Denmark) [17]-[21]. UK: Thoburn v Sunderland CC (UK), [62]-[63]. Ireland: Crotty (Ireland), 600-601, 770. Czech Republic: Lisbon II (Czech Republic) [136], [150], [170]. Poland: 9 Lisbon (Poland), grounds 2.2 et seq. Latvia: Re Lisbon (Latvia), 52-53. Lithuania: On limitation of rights of ownership (Lithuania) [9.4]. Hungary: Lisbon (Hungary).

\textsuperscript{576} Lisbon (Poland), ground 2.4.

\textsuperscript{577} Re Lisbon (Germany) [204]. See also: Kumm (2012), 44 ‘It is not clear why it would undermine the status of EU law as law that is another legal system that incorporates EU law on its own terms... they are not thereby undermining the status of EU law as law properly so called.’

\textsuperscript{578} See, e.g., SPUC v Grogan I (Irish Supreme Court), 769, per Walsh J: ‘it cannot be one of the objectives of the [EC] that a member state should be obliged to permit activities which are clearly designed to set at nought the constitutional guarantees for the protection within the State of a fundamental human right... The interpretation of the Constitution of Ireland is within the exclusive competence of the courts of Ireland.’

\textsuperscript{579} See, e.g., Melloni (Spain), 23: ‘equivalence and sufficiency in [constitutional] protection... only becomes clear... when there is an underlying legitimate trust in Community institutions and other Member States.’ See also: Murkens (2010), 532, ‘There is the thorny issue of “trust”: although the court “trusts” EU institutions ... it tacitly confirms Jon Hart Ely’s thesis that democracy and trust go hand in hand.’ See also: Fontanelli and Martinico (2008) 22: ‘the ECJ will be called to demonstrate that it deserves the trust showed by the Corte costituzionale and behave in a careful and cooperative way.’

\textsuperscript{580} Eurojust [24]; Marrosu and Sardino [40]; Case C-324/07 Coditel Brabant [2008] ECR 1-8457 (Opinion of AG Trstenjak) [85] (identifying regional and local self-government as part of national identity); Michaniki (Opinion of AG Maduro) [30]-[35] (discussing identity in relation to the Greek constitutional prohibition on media companies participating in procurement); Rottman (Opinion of AG Maduro) [23]-[25] (identifying the regulatory authority of Member States in the realm of citizenship as part of national constitutional identity). For discussion: Leonard Besselin, ‘National and Constitutional Identity Before and After Lisbon’ (2010) 6 Utrecht L Rev 44, 41; Preshova (2012).

\textsuperscript{581} Case C-364/10 Hungary v Slovakia (Grand Chamber, 16 October 2012); Case C-566/10 Italy v Commission (Grand Chamber, 27 November 2012) (Italian point about constitutional identity not mentioned).

\textsuperscript{582} O’Brien [49] (rejecting a claim by the Latvian government that Directive 97/81 does not respect Art 4(2) TEU and holding that the directive ‘cannot have any effect on national identity.’); Torresi [58]. See also: the criticism by the Czech Ústavní Soud in Slovak Pensions XVII (Czech Republic).

\textsuperscript{583} Sur this point: Besselin (2010), 41; Preshova (2012). See the decision Michaniki (Opinion of AG Maduro) [55]-[57].
history of EU integration, the ECJ has struck down just one piece of legislation for being *ultra vires* EU Law.\(^{584}\) As Judge Pescatore has written, the stated teleology of Europe’s judges is integration:

‘[T]he interpretation of Community Law depends not on the idea of maintaining an equilibrium which has been reached but on the vision of a European unity which is to be built.’\(^{585}\)

Accordingly, the European courts are seen to have ‘laboured in the field of doctrine to extend the Community’s competences’, \(^{586}\) ‘stretch[ed] their competences to the outermost limits and bring home the reality of European integration’, \(^{587}\) and evinced a school of thought that ‘no opportunity should be missed of moving the Community caravan forward, if necessary by night marches.’\(^{588}\)

Criticisms of a ‘dialogue among the deaf’ and a fundamental ‘lack of respect for the constitutional traditions of the Member States’ have been levelled against the ECJ in those cases where integral constitutional principles have been placed faithfully before it.\(^{589}\)

The normative supremacy of uniformity and effectiveness of EU legislation does not provide an authoritative description of the law for the purposes of this thesis. In *Fragd*, for example, the *Corte Constituzionale* stated that compared to the inalienable rights of man, ‘concerns of uniform


\(^{585}\) According to Pescatore, it is in light of this integrationist teleology that ‘the scope of the Treaties can be clarified, that competences can be defined [and] gaps filled.’ Pescatore (1970), 174.


application of Community law and legal certainty did not have any overriding force.’ Likewise, in Grogan (Ireland) the Irish Supreme Court stated:-

‘Where an injunction is sought to protect a constitutional right, the only matter which could properly be capable of being weighed in a balance against it would be another constitutional right… there can be no question of a possible or putative right which might exist in European law as a corollary to a right to travel so as to avail of services, counterbalancing [that right] as a matter of convenience.’ Simply put, Member State constitutional courts do not weigh EU law and constitutional identity in accordance with the normative weight the ECJ ascribes to them. They are not authorised to decide that EU guarantees should persist while constitutional guarantees should perish. In any event, the Cassandra scenario is, by now, disproven. National constitutional courts are not legislators. Courts cannot claw back competences through later-in-time legislation. The Costa justification for supremacy, that EU law would be ‘quite meaningless if a State can unilaterally nullify its effects by means of a legislative measure’ is quite irrelevant in this context – and is seen as so by Member State constitutional courts.

1.2.2.3 Positive Evaluation of Constitutional Identity Review

Constitutional and normative claims being weighed, this thesis is ultimately concerned with what will happen in a conflict. It is concerned with whether – as the ECJ maintains – it is the sole arbiter of what is and is not an infringement of constitutional identity, or whether national courts may still threaten the good functioning machineries of public economics placed within their jurisdiction (regardless of what they are told).

Against that standard, the merits for accepting the EU supremacy claim as a factual statement of the law are dubious. Article 4(2) TEU may be said to constitute a material (merely persuasive) competence to blunt an EU measure before it protrudes over the boundaries of the EU legal order, but Member States do not accept the supremacy of this assessment over their own. This was

590 Fraga (Italy) 653-62. The Conseil Constitutionnel similarly refuses to abandon its identité constitutionelle jurisdiction, because ECJ jurisprudence does not prevent EU law ‘having such a broad ambit and taking effect in such a manner as to affect the essential conditions for the exercise of national sovereignty.’ Re Amsterdam (France) [4], [23].

591 SPUC v Grogan I (Irish Supreme Court), 765.

592 Re Lisbon (Germany) [192] (‘The principle of democracy may not be weighed against other legal interests; it is inviolable’); UN Convention (Italy) [3.2] (‘The examination [of constitutionality] is a task of the constitutional judge alone... any different solution goes against the exclusive competence given by the Constitution to this Court’).

593 Kumm, ‘Final Arbiter’ (1999), 361points out that national constitutional courts have had this jurisdiction for the entirety of European integration, and there is no material evidence of the Cassandra scenario.

594 Costa v ENEL.

595 Winner Wetten [67]. Cf: Re Lisbon (Germany) [211], [216].

596 This is so even among those which do not engage in open conflict. See, e.g., House of Lords, The Future Role of the European Court of Justice (6th Report, 2004), para 65 per Paul Craig, ‘It is not just that we have positive counter examples in the form of [Brunner, Carlsen] and cases of that sort, but also from the scholarship that I have read, I do not know of any constitutional court which has unequivocally ever said that they admit that the ECJ has the ultimate Kompetenz-Kompetenz.’ See further: Groussot (2008), 99 (‘no courts have expressly acknowledged the ultimate authority
demonstrated in Solange I (Germany), Slovak Pensions XVII (Czech Republic),\textsuperscript{598} and EAW 2735/14 (Germany),\textsuperscript{599} for example, where national courts in fact invalidated the effects of ECJ rulings, and these decisions were in fact taken as an authoritative statement of law by the legal system.\textsuperscript{600}

By contrast, where the CJEU has asserted itself over constitutional identity, the jurisdiction has proven so constitutionally fraught that its very use is prejudicial the integrity of the European legal order. It must not be forgotten that it was precisely that phenomenon in Internationale Handelsgesellschaft which provoked the birth of ‘constitutional identity’ jurisprudence in the first place.\textsuperscript{601} More recently, the direct application of supremacy to ‘constitutional identity’ in such ECJ rulings as Åkerberg Fransson\textsuperscript{602} and Melloni\textsuperscript{603} provoked a broader resistance to supremacy in Melloni (Spain),\textsuperscript{604} EAW (2735/14) (Germany),\textsuperscript{605} and Anti-terror Database (Germany),\textsuperscript{606} where constitutional courts attacked the ECJ’s reasoning, culminating in the effects of those decisions being effectively invalidated in Germany. Similarly, in Gauweiler v Bundesbank III, the BVerfGE inveighed against the reasoning of the ECJ placed six conditions on the operation of a (technically supreme) ECB bond-buying programme.\textsuperscript{607} Likewise, in Marie Landtová, the straight application of

of the Court of Justice. Indeed, national constitutions … have been framed in such a way that the final constitutional, legislative and judicial authority lies in the Member State.’); De Witte, ‘The Nature of the Legal Order’ (2011), 351 (absolute supremacy ‘implies that national courts, when acting on the duties imposed by them by the European Court, are exercising a jurisdiction attributed to them directly by Union law, and not a jurisdiction given to them by their own constitution.’); Preshova (2012), 292: ‘one cannot expect constitutional courts to rule contrary to their constitution when an interpretation accommodating both EU and national law interests is not feasible.’ On material authority: Schilling (1996), 407.

\textsuperscript{598} Slovak Pensions XVII (Czech Republic). For criticism: Komárek (2012).

\textsuperscript{599} EAW (2735/14) (Germany).

\textsuperscript{600} In Solange II (Germany), the BVerfGE held that it would not exercise its human dignity jurisdiction ‘so long as’ the ECJ maintained an equivalent level of identity protection, but in EAW (2735/14) (Germany) it failed to do so, and the BVerfGE overturned a decision of a German Higher Regional Court, acknowledging that this was even though ‘the Higher Regional Court’s decision is determined by Union law.’

\textsuperscript{601} Internationale Handelsgesellschaft; Frontini (Italy); Solange I (Germany). See: Grousset (2008), 99.

\textsuperscript{602} Åkerberg Fransson [20]-[21][holding that its jurisdiction to interpret legislation extended to legislation within the ‘scope’ of EU law – not just when it is ‘implementing’ EU law, in a case involving the ne bis in idem principle.

\textsuperscript{603} Melloni; Melloni (Opinion of AG Bot) (a case involving trial in absentia did not fall within the ‘core’ of Spanish constitutional identity).

\textsuperscript{604} In Spain the response of the Tribunal Constitucional was to reassert its refutal of EU supremacy over the ‘material limits’ of constitutional identity (at [3]) and reassert its authority to apply a level of protection higher than the Chater – something which conflicts with ECJ jurisprudence under Article 54 of the Charter. The court resolved the case by concluding that the complainant had waived his right not to be tried in absentia (at [1]-[2]). See: Bessielink 92014), 531.

\textsuperscript{605} EAW (2735/14) (Germany). Responding specifically to Melloni, the BVerfGE directly criticised the ECJ’s treatment of identity ([78]-[80]), asserted its own constitutional identity over the decision, and then invalidated a European arrest warrant that the dock said had been ‘determined by Union law.’ At [82]-[84] stating that although the ECJ ‘specifically ruled’ that execution of a warrant could not be conditional on compliance with constitutional law, this did not release German authorities and courts of the obligation to secure the principles of [human dignity].

\textsuperscript{606} Anti-terror Database (Germany) the BVerfGE issued an explicit rebuke to the ECJ’s ruling in Åkerberg Fransson, refusing to submit a reference in an area partially governed by EU law and declaring the Fransson ruling was itself inapplicable in Germany (at [88]-[89], [91]): ‘[Fransson] must not be read in a way that would view it as an apparent ultra vires act … in a way that questioned the identity of the Basic Law’s constitutional order … [Fransson] must thus not be understood and applied in such a way that absolutely any connection of a provision’s subject-matter to the merely abstract scope of Union law, or merely incidental effects on Union law, would be sufficient for binding the Member States.’

\textsuperscript{607} Gauweiler III (Germany)
supremacy to Czechoslovakian dissolution arrangements provoked an *ultra vires* ruling by the 
Ústavní Soud so vociferous it bears full repetition here:-

‘[The Ústavní Soud] expected that, at least in order to preserve the appearance of objectivity, 
the ECJ would familiarize itself with the arguments that respected the case law of the 
Constitutional Court and the constitutional identity of the Czech Republic, which it draws from 
the common constitutional tradition with the Slovak Republic, that is from the over seventy 
years of the common state and its peaceful dissolution, i.e., from a completely idiosyncratic 
and historically created situation that has no parallel in Europe…

The failure to distinguish legal relationships arising from the dissolution of a state with a 
uniform social security system from legal relationships arising from the free movement of 
persons in the European Communities… is a failure to respect European history; it is 
comparing matters that are not comparable. For this reason it is not possible to apply European 
law … it is not possible to do otherwise than to find … that an act *ultra vires* has occurred.’

Perhaps the twenty-eight legal guardians of Europe’s constitutional democracies can be convinced of 
the ‘Cassandra’ scenario, and lay down their claim to adjudicate upon the rule of law under national 
constitutions. However, it suffices to state here that they are not so far convinced, and nearly every 
constitutional court – even the most communautaire among them - has invalidated or interpreted EU 
law in conformity with national constitutional identities, rather than the other way around. If this has 
averted such open conflicts, it has nonetheless led to a diffusive realm of ‘parallel’ interpretations 
where EU law is nonetheless invalidated or warped against the shape of constitutional identities. This 
can be seen in *AAA v Strix (Sweden)*, *Gauweiler (Germany)*, *EAW (Cyprus)*, the Portuguese 
financial conditionality cases, *EM Eritrea (UK)*, *Grogan (Ireland)*, *ESM (Estonia)*, *Sugar*

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608 Slovak Pensions XVII (Czech Republic), 12-13. Anticipating that the issue of constitutional identity would not be 
raised by the parties, the Ústavní Soud sent submissions explaining its case law to the ECJ. These were rejected, and the 
issue constitutional identity was not raised. When the dissolution agreement next came before the Ústavní Soud, it 
declared the CJEU’s decision in *Landtová an ultra vires* violation of constitutional identity. For comment, see: Komárek 
(2012), 331.

609 *AAA v Strix (Sweden)* (refusing to submit a preliminary reference as required by EU law and instead treating the issue 
as one of purely internal national law).

610 Gauweiler I (Germany), Gauweiler III (Germany) (placing six conditions on the application of the ECB’s OMT 
programme). See also: European Arrest Warrant (2 BvR 2236/04) (Germany) (Case 2 BvR 2236/04) available at: 

611 *EAW (Cyprus)* (national implementation of EAW Framework Decision unconstitutional).

612 Ruling on the 2011 State Budget Law LOE2011 (Portugal) (Case 396/2011) of 21 September 2011 (Tribunal 
Constitucional); Ruling on the 2012 State Budget Law LOE2012 (Portugal) (Case 353/2012) of 5 July 2012 (Tribunal 
Constitucional). Note, however, that the CJEU has repeatedly denied that the policies considered by the Portuguese court 
were not acts of EU institutions, though the Portuguese court considered them to be so. See also: ERDF (Portugal).

613 *EM (Eritrea) (UK)* (interpreting the the ECJ’s ruling in *NS (Afghanistan)* (on article 4 of the Charter EU law) in 
conformity with the Human Rights Act 1999 (rather than the other way around).

614 *SPUC v Grogan I (Irish Supreme Court)*; *AG v X (Ireland)* (right to life not subject to free movement provisions).

615 *ESM (Estonia)* (although not an EU institution from the perspective of the ECJ, the Rijffikous considered it a creature 
of the EU for the purposes of national constitutional law, and adopted a different interpretation to the ECJ, placing limits 
on the capital call provisions of the ESM).
Quotas III (Czech Republic), EAW (Poland), Riga Land Use (Latvia), Data Retention (Romania) and Procurement Complaints (Romania), DI.KATSA (Greece), and Agricultural Surplus Stocks (Hungary), where courts exercised a sort of ‘reverse-Simmenthal’ supremacy. As the European Law Journal editors wryly point out, EU primacy vis-à-vis the national pouvoir(s) constituant(s) grants the ECJ ‘a power that perhaps can only exist as long as it is not made use of.’

A power that can ‘perhaps exist as long as it is not made use of’ cannot offer an authoritative statement of law for the purpose of this thesis. Constitutional courts have stated (and demonstrated) that legal architectures will be invalidated if they impinge on national constitutional identities, and this study must take them at their word.

1.3 The Constitutional Boundaries of European Fiscal Federalism

Having established that Member State ultra vires and constitutional identity jurisdictions provide a valid constitutional, normative and positive description of the constitutional boundaries of EU law, the remainder of this chapter will establish the precise substantive boundaries which impinge upon the field of fiscal federalism in the EU.

1.3.1 Fiscal Sovereignty

The first constitutional boundary pursued in this thesis is the principle of national fiscal sovereignty. That principle is implicitly but plainly impressed upon the allocation of competences in economic policy (Articles 2(3) and 5(1) TFEU) and the substantive provisions governing public finance (Articles 121-126 TFEU). The Union competence for economic policy under these articles is one of ‘mere coordination,’ limited to providing ‘a framework to coordinate these policies to a certain degree.’ The EU has no competence to determine the content and composition of government

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616 Sugar Quotas III (Czech Republic) (the national court retains for itself the ability to determine ‘whether an act of the Union has exceeded the limits [of powers] which the Czech Republic transferred to the EU under Art 10a of the Constitution.’)

617 EAW (Poland) (invalidating the national implementation of the EAW Framework Decision).

618 Riga Land Use Plan (Latvia), 60: ‘Latvian law must be interpreted so as to avoid any conflicts with the obligations of Latvia towards the European Union, unless the fundamental principles incorporated in the Satersme are affected.’

619 Data Retention (Romania) and Procurement Complaints (Romania) (both ruling that the national implementation of EU rules were unconstitutional, but only on the basis of the manner of implementation).

620 DI.KATSA (Greece) (in resolving a conflict between Directive 89/48 and Art 16(5) of the Constitution: the constitutional guarantee of public education was ‘clearly necessary for the preservation of the national identity.’)

621 Agricultural Surplus Stocks (Hungary) (invalidating several provisions of a national implementing act concerning two Commission regulations as unconstitutional). While formally ambiguous in that the court only ruled on Hungarian national law, other clues, such as the fact that it was not necessary to interpret the measures as retroactive, indicate an assertion of reverse-Simmenthal supremacy: Sadurski (2014).

622 Sadurski (2014).

623 Agustín José Menéndez, 'Editorial: A European Union in Constitutional Mutation' (2014) 20 ELJ 127, 133: ‘A ruling of the ECJ fining say the French state for a wrong transposition of [the TSCG] after the transposition was enshrined into the French Constitution and approved in a referendum would perhaps be the last judgement ever rendered by the ECJ.’

624 Fabbrini (2013), 35.

625 Hinarejos, 'Limits to Fiscal Integration' (2014), 244. See: Pringle v Ireland [64], ‘arts 2(2) and 5(1) TFEU restrict the role of the Union in the area of economic policy to the adoption of coordinating measures.’ See further: Gauweiler I
revenues and expenditures, dictate structural reforms, or determine social allocations at national level.\textsuperscript{626} That power belongs exclusively to the Member States.

This is not a mere reflection of good administration under the principle of subsidiarity (though it undoubtedly coheres with that principle).\textsuperscript{627} The principles enshrined in this area are not efficiency, but constitutional democracy and popular sovereignty. As the BVerfGE so puts it, fundamental decisions on public finance and expenditure are ‘a fundamental part of the ability of a constitutional state to democratically shape itself,’ ‘the core of parliamentary rights in democracy,’ and ‘an essential manifestation of constitutional democracy.’\textsuperscript{628} In short, national fiscal policy is the material substance of constitutional identity. Under Articles 2(3), 5(1), 120-121 and 126 TFEU, the economic and fiscal competences of Europe’s twenty-eight constitutional democracies remain completely outside the boundaries of the European legal order.

Notwithstanding any amendment to the Treaties \textit{de lege ferenda}, this forms an immutable boundary of the European legal order. Not only has economic policy not been conferred on the Union, but, according to the BVerfGE, it cannot ever be so conferred without abrogating the national constitutional identity and violating the ‘eternity clause’ (Article 79(3)) of the 1949 German Basic Law.\textsuperscript{629} The BVerfGE has, since its \textit{Lisbon} decision, consistently linked the budgetary power of the German Bundestag to the democratic federal state shielded by the ‘eternity clause.’ In that case, it held:

‘A transfer of the right of the Bundestag to adopt the budget and control its implementation by the government [would] violate the principle of democracy … in its essential content.’\textsuperscript{630}

Numerous other constitutional courts have drawn similar boundaries around fiscal sovereignty.\textsuperscript{631} In \textit{TSCG (France)} the Conseil Constitutionnel held that Articles 120-126 TFEU could ‘not result in the

\textit{(Germany)} [39], ‘In this field of economic policy, the European Union is … essentially limited to a coordination of Member States’ economic policies... the responsibility for economic policy lies clearly with the Member States.’\textsuperscript{626} As De Nederlansche Bank (2004), 27 notes, ‘the transfer of sovereignty relates solely to the balance of revenues and expenditures, and not to their level of composition.’\textsuperscript{627} European Commission, ‘Towards a Stability Pact’ (Note for the Monetary Committee) II/011/96-EN, 10 January 1996, 14: ‘There are sensitive issues concerning parliamentary sovereignty over budgetary policy, and in any case no single model would be appropriate given the diversity of historical and constitutional backgrounds.’ See also: Dawson and de Witte (2013), 822 (arguing that this non-application of subsidiarity improves the legitimacy and stability of the union ‘by explicitly allocating policy competences to the level of governance best able to meet the desires of the citizen.’)\textsuperscript{628} \textit{Aid Measures for Greece (Germany)} [107], [127]; \textit{Re Lisbon (Germany)} [228], [232]; \textit{Aid Measures for Greece (Germany)} [107], [127]; \textit{Re ESM I (Germany)} [193], [196]; \textit{Re ESM II (Germany)} [161]-[165]; Gauweiler I (Germany) [28]; Gauweiler II (Germany).\textsuperscript{630} \textit{Re Lisbon (Germany)} [228].

\textit{France: Re Maastricht I (France)} [43] (EMU affected the ‘essential conditions for the exercise of national sovereignty,’ requiring constitutional amendment); \textit{Re Maastricht II (France)} [31]-[35], [42]-[43]; \textit{TSCG (France)} [16] (as part of ‘the essential conditions for the exercise of national sovereignty’ Articles 120-126 TFEU ‘do not result in the transfer of any powers over economic or fiscal policy’). Ireland: \textit{Crofty (Ireland)}, 78; \textit{Pringle I (Ireland)} [8.14]; \textit{Collins (2013) IEHC 530 [95]-[98]. Poland: Lisbon (Poland), 200 (‘The attributes of sovereignty include: … ‘conducting an independent financial, budget and fiscal policies.’); ESM & TSCG (Poland) (Decision 2011/199/EU, the ESM and TSCG ‘do not confer a competence in economic policy on the Union.’) Estonia: \textit{ESM (Estonia)} [105], [106], [144] (ESM constitutional commitments cannot be increased without approval of parliament). Czech Republic: \textit{Lisbon I (Czech

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transfer of any powers over economic or fiscal policy,’ and so did not ‘infringe the essential conditions for the exercise of national sovereignty.’ In Lisbon (Poland) the Trybunal Konstytucyjny held that the conduct of ‘independent financial, budget and fiscal policies’ is one of the ‘attributes of sovereignty’ comprising Poland’s constitutional identity. The Spanish Tribunal Constitucional holds that budgetary autonomy is the essence of ‘the ability to self-government, expressed especially in the possibility of developing [a region’s] own policies or matters within their range of competence.’ In Crotty (Ireland), the Irish Supreme Court held that the freedom to form economic policy ‘is just as much a mark of sovereignty’ as the sovereign freedom to legislate itself, such that the desire to ‘qualify, curtail or inhibit the existing sovereign power …is not within the power of the Government itself.’ In Collins (Ireland), the court stressed that “Budgetary allocation is a fundamental responsibility which [the] Constitution cast upon the Dail… This constitutional responsibility may under no circumstances be abrogated, whether by statute, parliamentary practice or otherwise.” In a string of 2011 rulings on the constitutionality of the ESM legal framework before the Irish Supreme Court, the German BVerfGE, the Austrian VfGH, the Finnish Republic) [91], [93], (‘These principles can not be touched even by an amendment to the Constitution implemented formally in harmony with law…’). Spain: Catalonia v State Solicitor DTC 134/2011 (Spain) [8](a). Austria: ESM (Austria) [104]-[105] (ESM does not require total revision procedure because it does not abdicate fiscal sovereignty – it is precisely limited). Finland: Opinion on the Six Pack (Finland); Opinion on the Six Pack II (Finland); Six Pack III (Finland) (Articles 136 and 126 are not an adequate legal basis for economic policies with a significant impact on Parliament’s budgetary powers).

TSCG (France) [16] (referring to economic and fiscal policy as part of the ‘essential conditions for the exercise of national sovereignty), [30] (the ECJ jurisdiction over the implementation of EU budgetary laws under the TSCG did not ‘infringe the essential conditions for the exercise of national sovereignty’ because it did not give the ECJ the ability to ‘assess within this framework whether the provisions of the Constitution are compatible with the terms of this Treaty’), and at [31] (‘the Economic Partnership Programme required by the TSCG and Regulation 473/2013 did not violate national sovereignty because ‘the existence of such a programme does not have any binding consequences under national law.’).

Lisbon (Poland), 200. See also: ESM & TSGC (Poland), 305 (‘there is no correlation between [136(3) TFEU] and the ratification of [Decision 2011/199/EU]’), 308 (Poland not legally bound by the ESM Treaty), and 313 (unlimited budgetary obligations would violate the requirement to ensure that competences are conferred only ‘in relation to certain matters’).

Catalonia v State Solicitor DTC 134/2011 (Spain) [8](a): ‘[T]he political autonomy of the Autonomous Communities has been described in our case-law as the “ability to self-government, expressed especially in the possibility of developing their own policies or matters within its range of competence. … In other judgments we have explained that this autonomy implies that the incomes are fully available without undue constraints.” In a series of cases on budgetary stability laws enacted to meet the budgetary targets of the Union, the court held that budgetary autonomy had not been infringed because the budgetary rules did not establish a competence in fiscal policy, but a common objective or duty. Crucially, it did not entail specific ‘questioning of the establishment of local policies’ or exhaust the possible content of basic regulation in the matter.’ See: Catalonia v State Solicitor DTC 134/2011 (Spain) [8](a); Generalitat Asturias v State Solicitor (Law 18/2001 on Budgetary Stability) (Spain) DTC 157/2011 of 18 October 2011 [2011] 275 BOE 51 (Tribunal Constitucional) [7](b) (the policy of budgetary stability under EU law and the constitution is not a short-term instrument of economic policy, but a basic principle from the economic point of view); Generalitat Catalonia and Gobierno de Aragón v State Solicitor (Law 18/2001 on Budgetary Stability) (Spain) DTC 195-196/2011 of 13 December 2011 [2012] 9 BOE 61; [2012] 9 BOE 78 (Tribunal Constitucional) [3]-[4]. See also: Generalitat Asturias, Parliament of Castilla-La Mancha and others v State Solicitor (Organic law 5/2001 and Law 18/2001 on Budgetary Stability) (Spain) DTC 185-189/2011 of 23 November 2011 [2011] 306 BOE 53, 66, 82, 98, 115 (Tribunal Constitucional).

Ireland: Crotty (Ireland), 783 per Walsh J. See also: Pringle I (Ireland Supreme Court) [8.14].

Collins v Minister for Finance [2013] IEHC 530 [95]-[98].

Spending obligations ‘must come from funds already committed by Ireland (with the approval of the Dáil).’ Pringle I (Ireland Supreme Court) [8.14] per Clark J.
Perustuslakivaliokunnan, the Polish Trybunals Konstytucyjny and the Estonian Riijikohus, the legality of the ESM was predicated on the conclusion that financial commitments to the ESM were capped to the extent of the parliamentary authorisation, and so the Treaty did not entail an open-ended transfer of fiscal sovereignty.

In all countries which have identified fiscal sovereignty within their constitutional identity jurisdiction, national parliamentary control over budgetary policy is what separates a (constitutional) exercise of sovereignty from an (unconstitutional) abrogation of constitutional identity. A trespass on budgetary autonomy would require the Member States repudiate the advance (refusing to ratify the EU law) or withdraw from the Union altogether.

The remainder of this section will describe the contours of this jurisdiction and explain the tests applied by this thesis when assessing a possible impingement of fiscal sovereignty under the national constitutional identity jurisdiction.

1.3.1.1 The Eternity Clause of the 1949 German Basic Law

This thesis applies the German constitutional identity jurisdiction when testing EU law at the boundaries between legal orders. This is so for two reasons. First, much of the legal architecture at issue in this thesis derives directly from German constitutional constraints. The primary objective of price stability (Article 127(1) TFEU), the independence of the ECB (Article 130 TFEU), the prohibition on monetary financing (Article 123 TFEU), the ‘no-bailout’ rule (Article 125 TFEU) and the fiscal governance rules (Articles 121 and 126 TFEU), are all ‘parallel provisions’ to the German Basic law, and ‘permanent constitutional requirements of German participation in the monetary

638 Re ESM II (Germany) [161]-[162]: ‘As representatives of the people, the elected members of the German Bundestag must retain control of fundamental budgetary decisions even in a system of intergovernmental governing.’
639 ESM (Austria) [104]-[105] ‘According to the wording of Art. 8 para. 5 first sentence ESMV liability remains approved of each ESM Member “at all costs of its interest in thorised capital stock at the issue price limits.”’
640 Opinion 25/2011 on the ESM (Finland); Opinion 13/2012 on the ESM (Finland).
641 ESM & TSCG (Poland), 308: ‘Despite the applicants’ allegations, one may not speak of being bound by the ESM Treaty in a situation where the EU Member States whose currency is not the euro decide to participate on an ad hoc basis alongside the ESM …participation … is voluntary and takes place on the basis of bilateral agreements.’
642 In Estonia, ‘the maximum limit of Estonia’s [budgetary] obligations … cannot be changed without the consent of Estonia and without amending the Treaty’. ESM (Estonia) [105]-[106], [144].
643 ‘If one was to summarise the fundamental message of the German [identity jurisdiction] on the back of a business card, it would be the concern for the safeguarding of the budgetary powers and responsibilities of the Bundestag as the timeless embodiment of representative democracy in Germany.’ Bardutzky and Fahay, ‘Who Got to Adjudicate the EU’s Financial Crisis and Why?’ in Maurice Adams, Federico Fabbrini and Pierre Larouche (eds), The Constitutionalization of European Budgetary Constraints (Hart Publishing 2014) 341, 355.
644 See, e.g., Re Lisbon (Germany) [240]; Gauweiler III (Germany). The position is similar in Poland, though it remains outside EMU: Lisbon (Poland) [13].
645 Re Lisbon (Germany) [240]. The Polish, Spanish, and Italian Constitutional Courts have also held that a violation of national constitutional identity could require a withdrawal from the Union: Accession Treaty (Poland) [13]; Brussels Regulation (Poland), ground 2.7; Constitutional Treaty (Spain) [3]; Talamucci (Italy), 393 (referring to ‘the radical and disruptive remedy of the withdrawal from the European Union’).
union.’ In short, the boundaries of EU competence are carved directly from the limits of state power under German constitutional law.

Second, the so-called ‘eternity clause’ (Article 79(3) of the 1949 Basic Law) that grounds the German ‘constitutional identity’ jurisdiction is unusually strong and well-defined compared to other ‘identity’ provisions. It is the pinnacle of the German constitution and the high water-mark of constitutional identity in Europe. Put simply, while the EU may trespass on constitutional identity in any number of countries, it will most likely cross the limits of Article 79(3) BL first. Article 79(3) BL states:

‘Amendments of this Constitution affecting the division of the Federation in Länder, the participation on principle of the Länder in legislation, or the basic principles laid down in Articles I [Human Dignity] and 20 [Democratic and Social Federal State] are inadmissible.’

This provision is a permanent feature of German - and European - constitutional heritage. It is, according to the BVerfGE, an indelible consequence of history - ‘a reaction to the historical experience of a creeping or abrupt erosion of the free substance of a democratic fundamental order.’ It permanently shields the highest constitutional principles of the German state - human dignity (Article 1 BL) and the constitutive principles of the democratic social state (Article 20 BL) - from constitutional change.

The German constitutional identity therefore consists of two limbs: A human rights limb under the principle of human dignity (Article 1 BL); and a ‘constitutional democracy’ limb, consisting of the principles of the democratic social and federal State (Article 20 BL). The substance of these principles is then prescribed in greater specificity in other provisions which are themselves well-defined in BVerfGE jurisprudence. This has allowed the BVerfGE to identify a catalogue of rights shielded by German constitutional identity with an unusual degree of specificity.

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646 Re ESM I (Germany) [203].
647 Compare, e.g., Lisbon II (Czech Republic) (declining to catalogue a list of such powers, under Ar 9(2) of the Czech Constitution, [111]-[113]. See also: Danius Žalimas, President of the Constitutional Court of Lithuania, ‘Eternity Clauses: a Safeguard of Democratic Order and Constitutional Identity’ (Speech to the Constitutional Court of Kosovo, Pristina, October 2014), on Art 148 of the Lithuanian Constitution. Compare further: Art 110(2) of the Constitution of Greece; Title XVI, Art 89 of the French Constitution; Art 139 of the Constitution of Italy; Art 44(3) of the Austrian Constitution; Art 152 of the Romanian Constitution.
649 Grundgesetz (2013).
650 Re ESM I (Germany) [203]. See: Paul Gallagher, ‘Challenges to the ESM Treaty and the Fiscal Compact Treaty before the German Constitutional Court’ (2012) IIEA Working Paper No 10, 2, ‘this provision was introduced in order to ‘prevent Germany slipping back into dictatorship through the use of legal measures as under the Weimar Constitution.’
651 Solange I (Germany) [4]: ‘The part of the Basic Law dealing with fundamental rights is an inalienable, essential feature of the valid Basic Law ... Art 24 of the Basic Law does not without reservation allow it to be subjected to qualifications.’ Re Lisbon (Germany) [192]: ‘The principle of democracy may not be weighed against other legal interests; it is inviolable.’
652 The principles of human dignity incorporated directly in Article 1 BL consist of the inviolability of human dignity, inalienable human rights, and the direct enforceability of human rights against the state. These principles are in turn given substance by a catalogue of Basic Rights under Articles 2-17 BL, encompassing liberty, equality, conscience,
Under the constitutional democracy limb under Article 20, Article 79(3) BL not only entrenches the principle of democracy, but entrenches a specific formula for democracy. The principles of the democratic and social federal state incorporated directly into Article 20 BL consist of the democratic and social federal state, 654 popular sovereignty, 655 constitutional democracy, 656 the rule of law 657 and the right to resist the abolishment of the constitutional order. 658 This thesis is primarily concerned with with popular sovereignty and constitutional democracy. Here, Article 20(1) BL establishes the democratic and social federal state, and Article 20(2) BL provides it with that substantive content. Those provisions state:

(1) The Federal Republic of Germany is a democratic and social federal state.

(2) All state authority emanates from the people. It is being exercised by the people through elections and voting and by specific organs of the legislature, the executive power, and the judiciary. 659

The first sentence of paragraph (2) (Article 20(2)(i)) establishes the sovereignty of the people: All state authority emanates from the people, and it is the people which exercise state power. The second sentence (Article 20(2)(ii)) entrenches the principle of constitutional democracy: the people exercise state power through the act of voting and elections, through the specific organs of the legislature, the executive power, and the judiciary empowered under the constitution. This secures the constitutional link between the act of voting in elections and the exercise of state power. As stated by the court:

‘Article 20(2) sentence 2 guarantees in conjunction with art. 79(3) that the exercise of state duties and the exercise of state powers can be traced back to the people of the state and are accounted for vis-à-vis the people.’ 660

expression, family, education, assembly, association, communication, movement, work, home, property, citizenship and asylum rights.

655 For example, the principle of individual guilt has been linked to the rule of law (Articles 1(3) and 20(3) BL) and human dignity (Art 1 BL), in conjunction with Art 79(3) BL, even though it is not listed in Art 79(3) itself: EAW (2735/14) (Germany). See also: Hartley (2014), 261.

656 Art 20(1) Grundgesetz (2013): ‘The Federal Republic of Germany is a democratic and social federal state.’


658 Art 20(2)(ii) Grundgesetz (2013): ‘All state authority emanates from the people. It is being exercised by the people through elections and voting and by specific organs of the legislature, the executive power, and the judiciary.’

659 Art 20(3) Grundgesetz (2013): ‘Legislation is subject to the constitutional order; the executive and the judiciary are bound by law and justice.’

660 Art 20(4) Grundgesetz (2013): ‘All Germans have the right to resist any person seeking to abolish this constitutional order, should no other remedy be possible.’

661 Art 20(1) Grundgesetz (2013)

662 Re ESM II (Germany) [23].
The principles of popular sovereignty and democracy in Article 20(2) are then in turn given substance by the right to vote in Article 38(2) according to the formula in Article 38(1). That is, through general, direct, free, equal and secret elections of an autonomous Bundestag. A violation of the right to vote in Article 38 will therefore also constitute a violation of the German constitutional identity. Together, these provisions provide, in essence, that x powers must be exercised by y institution according to z formula. Article 38 BL states:

1) The deputies to the German House of Representatives [Bundestag] are elected in general, direct, free, equal and secret elections. They are representatives of the whole people not bound by orders and instructions, and subject only to their conscience.

2) Anyone who has attained the age of eighteen years is entitled to vote; anyone who has attained majority is eligible for election.

This provision has three sentences, each encasing a different component of the chain of legitimation between the voter and state power: First, Article 38(2) BL contains a positive, individual right to vote. This right, ‘as a right equivalent to a fundamental right,’ is the substantive manifestation of the principle of popular sovereignty and a stipulation of human dignity under Article 1 BL. The deprivation of this right is capable of grounding a claim under Article 79(3) BL.

Second, Article 38(1)(i) BL entitles all German citizens to take part in the election of the Bundestag through ‘general, direct, free, equal and secret elections.’ This establishes the link between the exercise of popular sovereignty - the act of voting itself, with the constitutional organ with the power of legislation. As stated in Lisbon (Germany):

‘The right to vote establishes a right to democratic self-determination, to free and equal state authority exercised in Germany and to compliance with the principle of democracy including the respect of the constituent power of the people.’

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661 Brunner (Germany) [34]-[35]; Re Lisbon (Germany) [151] (‘The Basic law has declared this legitimising connection between the person entitled to vote and state authority inviolable by art.23.1 in conjunction with art.79.3 and art 20.1 and 20.2 BL.’) and [184]-[187]. See also: Aid Measures for Greece (Germany) [102], [120]; Re ESM I (Germany) [192]; Re ESM II (Germany) [159].

662 Brunner (Germany) [34]-[35]: An encroachment on the right to vote in Article 38 ‘also comprises encroachments on the principles which are codified in art.79.3 … as the identity of the constitution.’ Re Lisbon (Germany) [184]; Aid Measures for Greece (Germany) [102], [120]; Re ESM I (Germany) [192]; Re ESM II (Germany) [159]. The right to vote has also been held to be a key component of the principle of human dignity in Article 1: Re Lisbon (Germany) [185]-[187].

663 Art 38 Grundgesetz (2013).

664 Brunner (Germany) [34]-[35]; Re Lisbon (Germany) [151] (‘The Basic law has declared this legitimising connection between the person entitled to vote and state authority inviolable by art.23.1 in conjunction with art.79.3 and art 20.1 and 20.2 BL.’) and [184]-[187];] Aid Measures for Greece (Germany) [98], [101], [120]; Re ESM I [192]; Re ESM II [159].

665 Aid Measures for Greece (Germany) [120].

666 Re ESM I (Germany) [191]; Re ESM II (Germany) [151].

667 That is, the constitutional accountability of state organs to the mechanisms of election in the constitution. Re ESM I (Germany) [192]; Re ESM II (Germany) [159].

668 Re Lisbon (Germany) [184]-[186]; Aid Measures for Greece (Germany) [120].
Third, under Article 38(1)(ii), the Bundestag is the representatives of the people, not bound by any orders or instructions, and subject only to the conscience of its deputies. This sentence protects the link between the right to vote (Articles 38(1)(i) and 38(2)) and the exercise of law-making power (Article 20(2)(ii)) by the organs of the state. This precludes any legal commitments entered into by Treaty (including those of the Union) ‘if the result of this is that the people’s democratic self-government is permanently restricted in such a way that central political decisions can no longer be made independently.’ The BVerfGE has repeatedly emphasised that Article 20(2)(ii) requires that the Bundestag remains accountable to the people which elect it. In Re ESM (Germany), the court held:

‘A necessary condition for the safeguarding of political latitude in the sense of the core of identity of the constitution (art.20(1) and (2), art.79(3) BL) is that the budget legislature makes its decisions on revenue and expenditure free of other-directedness on the part of the bodies and of other Member States of the European Union and remains permanently “the master of its decisions.”’

This entire machinery in Article 38 is subsumed within the principle of constitutional democracy (Article 20(2)) and shielded by the eternity clause of Article 79(3). It is not just a procedural right to free and equal participation in the election of the Bundestag as a body that is protected. It is a substantive right to ‘self-determination … in the exercise of public power’ - it is a right to the ‘substance of the power to rule.’

It must be emphasised here that Articles 38, 20 and 79(3) BL protect a specific formula for democracy. What is guaranteed under the German Constitution is not just ‘representative democracy’ in an openly-defined sense, or that in Article 10 TEU. This is a specific right to take part in the exercise of state power according to a specific formula – that is, by voting in general, direct, free, secret, and equal elections (meaning one person one vote) of a specific institution with specific characteristics: an autonomous Bundestag free of other-directedness which possesses the substance of the power to rule through legislating, appointing the Chancellor, and controlling the government (Articles 20(2) and 79(3) BL).

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670 Under Article 38(1)(ii), the right to elect the Bundestag is a right to elect an autonomous parliament. Aid Measures for Greece (Germany) [98], [120]; Re ESM I (Germany) [197]; Re ESM II (Germany) [164].
671 Aid Measures for Greece (Germany) [98], [101].
672 ‘Parliamentary responsibility to the citizens is the essential condition for the effective influence of the people on the exercise of state power which is called for by Art.20(2) sentence 2.’ Parliamentary Rights to Information (ESM and Euro Plus Pact) (Germany) (Case 2 BVerfGE 4/11): BVerfGE 131, 151 (English version) (Bundesfassungsrecht) [113] (emphasis added); Brunner (Germany) [35].
673 Re ESM I (Germany) [197]; Re ESM II (Germany) [164]. See also: Aid Measures for Greece (Germany) [127].
674 Re ESM I (Germany) [192]; Re ESM II (Germany) [151], [159].
675 Re ESM II (Germany) [224], [230].
676 Re ESM II (Germany) [235]; Re Lisbon (Germany) [225]-[228].
677 Re ESM II (Germany) [224], [230]; Aid Measures for Greece (Germany) [98], [120].
The ‘constitutional identity’ jurisprudence stemming from these provisions emerged in *Solange I (Germany)*, in which the BVerfGE held that the conferral of competences on the Union ‘does not confer a power to surrender by ceding sovereign rights to international institutions the identity of the prevailing constitutional order of the Federal Republic by breaking into its basic framework, that is, into its basic structure.’ 678 The constitutional democracy limb under Article 20 then emerged in *Brunner v EU Treaty*, where the BVerfGE held that ratification of the Maastricht Treaty did not violate the constitutional identity because the German *Bundestag* retained the core competences necessary for democratic self-determination and did not confer an open-ended *kompetenz-kompetenz* on the Union. 679 The parameters of this limb were then confirmed and clarified in *Re Lisbon (Germany)*, in which the BVerfGE held:

‘The principle of democracy may not be weighed against other legal interests; it is inviolable. The constituent power of the Germans which gave itself the Basic Law wanted to set an insurmountable boundary to any future political development. Amendments to the Basic Law affecting the principles laid down in art.1 and art.20 of the Basic Law shall be inadmissible (art.79.3 of the Basic Law). The so-called eternity guarantee even prevents a constitution-amending legislature from disposing of the identity of the free constitutional order.’ 680

Under Article 79(3) BL, these principles are inviolable. Any amendment affecting human dignity or the basic principles of the democratic social and federal state is unconstitutional. 681 They may not be weighed against any other legal interests (including the mandate of peace and integration and the

678 *Solange I (Germany)* [4]. Cf.:*Internationale Handelsgesellschaft*. In *Solange II (Germany)* and *Banananas (Germany)* the court held that it would not automatically review the validity of EU against Germany fundamental rights so long as EU protection was sufficient. See further: *EAW (2236/04) (Germany)* (invalidating the national implementation of the EAW Framework decision, though doing so on the basis of a misuse of discretion).

679 *Brunner (Germany)* [59]. See also: *Re ESM I (Germany)* [193]; *Re ESM II (Germany)* [160].

680 *Re Lisbon (Germany)* [192].

681 *Re Lisbon (Germany)* [192]-[194]: ‘Within the order of the Basic Law, the structural principles of the state laid down in art.20 of the Basic Law, i.e. democracy, the rule of law, the principle of the social state, the republic, the federal state, as well as the substance of elementary fundamental rights indispensable for the respect of human dignity are, in any case, not amenable to any amendment because of their fundamental quality.’ See also: *Solange I (Germany)* [4] ‘The part of the Basic Law dealing with fundamental rights is an inalienable, essential feature of the valid Basic Law.’

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constitutional principle of the openness towards EU law), they cannot be narrowed or disposed-of by constitutional amendment, and they cannot be weighed against the ‘constructive force of the mechanism of integration.’ Constitutional identity review does not, have some have argued, depend ‘on an assessment of the danger [that the Union] will in fact violate fundamental constitutional principles of Member States.’ As the BVerfGE has stated clearly, Article 79(3) BL does not require ‘cases of imminent totalitarian seizure of power’ for it to be exceeded. It cannot be transcended in the name of public good under a Schmittian state of exception, and so it cannot be interpreted in the light of the ‘effet utile’ or ultima ratio justifications seen to underlie recent EU crisis measures - no matter how meritorious. Indeed, it is precisely that argument which Article 79(3) is meant to guard against. Article 79(3) is no less inviolable if the motives of the transgressor are pure. The only way that these immutable principles may be changed is by enacting a new constitution upon a free decision of the German people under Article 146 BL (against which lies a right to resist the abolishment of the constitutional order under Article 20(4) BL).

Any break at each link the ‘chain of legitimation’ between the right to vote and the exercise of state power is prima facie capable of grounding a constitutional complaint for the infringement of that right, the protection of which is within German constitutional identity. If voters are no longer able to exercise the right to vote under 38(2) BL; if the right to vote is to be exercised by a method of voting other than the formula described in Article 38(1)(i); if votes are no longer connected to the

682 Brunner (Germany) [182]; Re Lisbon (Germany) [192]-[193]: ‘The principle of democracy may not be weighed against other legal interests; it is inviolable.’

683 Brunner (Germany) [182]; Re Lisbon (Germany) [192]-[193], [195], [216]; Aid Measures for Greece (Germany) [101] (‘the connection between the right to vote and state power is inviolable’); Re ESM I (Germany) [192]; Re ESM II (Germany) [159] (the right to vote is protected against interference by constitution-amending legislature).

684 Re Lisbon (Germany) [214].

685 Kumm, ‘Final Arbiter’ (1999), 359; Kumm, ‘The Jurisprudence of Constitutional Conflict’ (2005), 294; Gallagher (2012), 3 (‘The court fails to demonstrate why specific problems of the democratic organisation of the EU should trigger the ultimate barrier that is the “Eternity Clause”’).

686 Aid Measures for Greece (Germany) [10].

687 On the Ausnahmezustand, see: Carl Schmitt, Political Theology: Four Chapters on the Concept of Sovereignty (George Swab tr, MIT Press 1985), 5 (arguing that as the rule of law is subject to the state of emergency, and the sovereign can determine the state of emergency, the rule of law can be subverted).

688 Stefania Baroncelli, ‘The Independence of the ECB after the Economic Crisis’ in Maurice Adams, Federico Fabbrini and Pierre Larouche (eds), The Constitutionalization of European Budgetary Constraints (Hart Publishing 2014) 125, 143; Paul Craig, ‘Economic Governance and the Euro Crisis: Constitutional Architecture and Constitutional Implications’ in Maurice Adams, Federico Fabbrini and Pierre Larouche (eds), The Constitutionalization of European Budgetary Constraints (Hart Publishing 2014) 14, 27 (“We should be mindful of this Schmittian dimension, but it should nonetheless not precluded reasoned analysis of the legal difficulties attendant on measures enacted to meet the crisis.’

689 Weiler, ‘Does Europe Need a Constitution?’ (1995), 236 ‘Is it not just a little bit like the Weimer elections which democratically approved a non-democratic regime? Is it not the task of a constitutional court to be a counter balance to such self-defeating democratization?’

690 Art 20(4) BL states: ‘All Germans have the right to resist any person seeking to abolish this constitutional order, should no other remedy be possible. Art 146. Re Lisbon (Germany) [155] (‘Art 146 [BL] sets out, in addition to the substantive requirements laid down in art.23.1 … the ultimate boundary of the participation of [Germany] in European integration. it is the constituent authority alone, not the constitutional authority emanating from the constitution, which is entitled to release the state constituted by the Basic Law.’); Aid Measures for Greece (Germany) [101]. As the BVerfGE emphasised, ‘Citizens must be able to defend themselves in a constitutional court against the relinquishment of competences which is incompatible with Art 79(3) of the Basic Law.’

691 Brunner (Germany) [4]-[5].
Bundestag named in Article 38(1)(ii); or if the Bundestag has been deprived of the substance of the power to rule by conferral or ‘other-directedness’ (Article 20(2) BL) - then the chain of legitimation will be broken.\textsuperscript{692} Under Articles 38 and 20, in conjunction with Article 79(3)BL, it is the substance of the power to rule which is protected by the eternity clause:

‘The right to vote also comprises the fundamental democratic content of the right to vote, that is, the guarantee of effective popular government. Article 38 [BL] protects the citizens with a right to elect the Bundestag from a loss of substance of their power to rule, which is fundamental to the structure of a constitutional state, by far-reaching or even comprehensive transfers of duties and powers of the Bundestag, above all to supranational institutions.’\textsuperscript{693}

1.3.1.2 The Constitutional Safeguard Clause of the 1949 German Basic Law

How, then, is EU legislation to be squared with that formula? Under Article 10 TEU, the Treaties legitimise power entirely differently. It is not the German people in Article 38(2) BL which exercise state power, but the peoples of Europe (represented by the Parliament, the Council, and the Commission).\textsuperscript{694} EU Parliamentary elections are not taken in the general, direct, free and equal manner prescribed by Article 38(1)(i) BL, and the Bundestag in Article 38(1)(ii) BL does not govern (nor for that matter, does the European Parliament). Within the EU legal order, political accountability is not to the voters in Article 38(2), in accordance with the manner prescribed in Article 38(1), as guaranteed by the principle of democratic government in Article 20(2) and 79(3) BL.\textsuperscript{695}

Instead, within the scope of EU law, constitutional identity is safeguarded by the constitutional safeguard clause (‘Verfassungsbestandsklausel’) in Article 23 BL. Article 23 BL is the gateway through which EU law flows into the German legal order.\textsuperscript{696} It establishes an ‘exception’ to the constitution which allows for democratic opinion-forming to be shaped in ways different to that envisioned under Article 38 BL.\textsuperscript{697} Article 23(1) BL states:

\textsuperscript{692} In Brunner (Germany) [4]-[5], [172], [341], the court held that the right to vote may be violated through relocations of duties and powers of the Bundestag to the EU if those resulted in structural changes in competences which deprived the citizens of the ability to make choices about the exercise of their powers. See also: Aid Measures for Greece (Germany) [102]. Article 38(1) takes effect where a ‘danger clearly exists that the competences of the present or future Bundestag will be eroded in a manner that ‘legally or de facto makes parliamentary representation of the popular will … impossible.’

\textsuperscript{693} Brunner (Germany) [4]-[5]. See also: Re Lisbon (Germany) [184]-[186]; Aid Measures for Greece (Germany) [98].

\textsuperscript{694} Parliamentary Information (ESM & EPP) (Germany) [96] ‘it is not primarily the national legislative bodies which act through the European Council and the Council, but the executives of the Member States.’

\textsuperscript{695} Parliamentary Information (ESM & EPP) (Germany) [96], ‘When this law is passed, it is not primarily the national legislative bodies which act through the European Council and the council, but the executives of the Member States. The political ideas on which the legislation is based are laid down with regard to the general political objectives by the European Council … and the Commission. Above all, the Council … is responsible for establishing policy and - as a general rule jointly with the European Parliament - is the central legislative body.’

\textsuperscript{696} In Brunner (Germany), the BVerfGE held that European law could not apply in Germany of its own force but was ‘transported’ into the German legal system by the act on ratification.

\textsuperscript{697} Re Lisbon (Germany) [195].
‘To realize a unified Europe, Germany participates in the development of the European Union which is bound to democratic, rule of law, social, and federal principles as well as the principle of subsidiarity and provides a protection of fundamental rights essentially equivalent to that of this Constitution. The federation can, for this purpose and with the consent of the Senate [Bundesrat], delegate sovereign powers. Article 79(1) & (3) is applicable for the foundation of the European Union as well as for changes in its contractual bases and comparable regulations by which the content of this Constitution is changed or amended or by which such changes or amendments are authorized.’

This provision provides for three things: First, it allows a simple majority in the Bundestag to ‘delegate’ sovereign powers to the EU with the assent of the Bundesrat. Second, as it ‘transfers’ sovereign powers, it grants supremacy to EU law conditional on a protection of fundamental rights ‘essentially equivalent’ to the Basic Law. Third, it contains a nemo plus iuris rule, which makes Article 23(1) and each act of conferral subject to the inviolable principles of the German constitutional identity contained in Article 79(3) BL. As stated by the BVerfGE, this creates an ‘exception’ to allow the rights in the Basic Law to be exercised in a manner other than prescribed in the constitution, but this only ‘applies as far as the limit of the inviolable constitutional identity (art.79.3 of the Basic Law)’ of which Article 20 and its machinery (Article 38) are a part. It allows Germany to enter a federation of sovereign states (but permits neither ‘submission removed from constitutional limitation and control nor the forgoing one’s own identity.’ The mandate to develop the European Union is subject to ‘permanent compliance with particular constitutional structural requirements, and that in this connection an absolute limit is created … to protect the identity of the constitution.’

In short, the powers conferred on the union can be conferred up to the hilt of 79(3), but no further. Those powers touched by the eternity clause must be exercised according to the formula specified in Articles 38, 20 and 79(3) BL, and within the scope of those powers, the chain of legitimation must remain intact. In Re Lisbon (Germany), the BVerfGE explained:

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698 Art 23(1) Grundgesetz (2013).
699 If the transfer of powers entails an amendment to the constitution, the ratification must be adopted by a two-thirds majority in both chambers. (Art 23(1) (third sentence) in conjunction with Art 79(2) BL).
700 See, e.g., Brunner (Germany); Re Lisbon (Germany); Bananas (Germany); Gauweiler III (Germany) [116]-[118].
701 It should be noted that Art 79(1) further precludes the Union from amending the German constitution. It states: ‘his Constitution can be amended only by statutes which expressly amend or supplement the text thereof. [2]In respect of inter- national treaties, the subject of which is a peace settlement, the preparation of a peace settlement or the phasing out of an occupation regime, or which are intended to serve the defense of the Federal Republic, it is sufficient, for the purpose of clarifying that the provisions of this Constitution do not preclude the conclusion and entry into force of such treaties, to effect a supplementation of the text of this Constitution confined to such clarification.’
702 Re Lisbon (Germany) [196].
703 Re Lisbon (Germany) [204].
704 Aid Measures for Greece (Germany) [101].
705 Re Lisbon (Germany) [194]-[196], [202]-[206].
706 Re Lisbon (Germany) [195].
‘The empowerment to embark on European integration permits a different shaping of political opinion-forming than the one determined by the Basic law for the Constitutional order. This applies as far as the limit of the inviolable constitutional identity (art.79.3). […]The minimum standard protected by art.79.3 of the Basic Law must not fail to be achieved even by Germany’s integration into supranational structures.’ 707

1.3.1.3 Fiscal Sovereignty

Since its Lisbon decision, the German Constitutional court has consistently linked the budgetary power of the German Bundestag to the right to vote (Article 38 BL) and the principles of popular sovereignty and constitutional democracy (Article 20(2) BL) shielded by the ‘eternity clause.’ 708 In that case, the court set about to identify the essential democratic substance of the democratic, social and federal state shielded by the ‘eternity clause’, enumerating a catalogue of inalienable, essential powers so ‘particularly sensitive for the ability of a constitutional state to democratically shape itself’ that they comprise the substance of self-government. Budgetary policy was among the most important of those powers. 709 It held:

‘Particularly sensitive for the ability of a constitutional state to democratically shape itself are … fundamental fiscal decisions on public revenue and public expenditure, the latter being particularly motivated, inter alia, by social policy considerations…

A transfer of the right of the Bundestag to adopt the budget and control its implementation by the government [would] violate the principle of democracy and the right to elect the German Bundestag in its essential content if the determination of the type and amount of the levies imposed on the citizen were supranationalised to a considerable extent. The German Bundestag must decide, in an accountable manner vis-à-vis the people, on the total amount of the burdens placed on citizens. The same applies correspondingly to essential state expenditure. In this area, the responsibility concerning social policy in particular is subject to the democratic decision-making process, which citizens want to influence through free and equal elections. […] What is decisive, however, is that the overall responsibility, with sufficient political discretion regarding revenue and expenditure, can still rest with the German Bundestag.’ 710

707 Re Lisbon (Germany) [205], [225]. See also: Brunner (Germany) [172]; Re Lisbon (Germany) [151], [186], [199]; Aid Measures for Greece (Germany) [98], [100] [104]; Re ESM I (Germany) [191]; Re ESM II (Germany) [151]-[159].
708 Re Lisbon (Germany) [228]; Aid Measures for Greece (Germany) [107], [127]; Re ESM I (Germany) [193]-[196]; Re ESM II (Germany) [161]; Gauweiler I (Germany) [28].
709 Aid Measures for Greece (Germany) [101], [104]; Re ESM I (Germany) [192]; Re ESM II (Germany) [159].
710 Re Lisbon (Germany) [228]-[232].
Under Articles 38, 20(2) and 79(3) BL, the competence to prepare the budget ‘lies solely with the legislature’ and ‘the Bundestag must make decisions on revenue and expenditure with responsibility to the people.’\(^{711}\) The integral factor in this regard is whether the Bundestag ‘remains the place in which autonomous decisions on revenue and expenditure are made, including those with regard to international and European liabilities.’\(^ {712}\) Fundamental decisions on revenue and expenditure must be legitimated by the people with the right under Article 38(2), in the manner set out in Article 38(1)(i) and exercised by the institution in Article 38(1)(ii) – that is, by the German people voting in free, equal, secret and direct elections of through an autonomous Bundestag free of ‘other-directedness.’\(^{713}\)

1.3.1.4 Unlawful Restrictions on Budgetary Sovereignty

The first way in which the principle of democracy might be depleted is through formal restrictions on Member State budgetary powers, ‘with the effect that it or a future Bundestag can no longer exercise the right to decide the budget on its own.’\(^{714}\) As representatives of the people under Article 38(1)(ii), not bound by any orders or instructions, the Bundestag ‘must retain control of fundamental budgetary decisions even in a system of intergovernmental administration.’\(^{715}\) If the German Bundestag were to find itself in the role of ‘mere subsequent enforcement’, it could ‘no longer exercise its overall budgetary responsibility.’\(^{716}\) In Aid Measures for Greece, the court stated that:

‘The fundamental decisions on public revenue and public expenditure are part of the core of parliamentary rights in democracy. Article 38.1 excludes the possibility of depleting the legitimation of state authority and the influence on the exercise of that authority provided by the election by fettering the budget legislature to such an extent that the principle of democracy is violated.’\(^{717}\)

\(^{711}\) Budgetary accountability is through the Bundestag and the Bundesrat under Article 114 BL: Aid Measures for Greece (Germany) [122]; Re ESM I (Germany) [195]; Re ESM II (Germany) [161]; Parliamentary Information (ESM & EPP) (Germany) [114].

\(^{712}\) Re ESM I (Germany) [195]; Re ESM II (Germany) [161]-[165].

\(^{713}\) Aid Measures for Greece (Germany) [101]; Re Lisbon (Germany) [225].

\(^{714}\) Re ESM I (Germany) [195]; Re ESM II (Germany) [161].

\(^{715}\) Aid Measures for Greece (Germany) [124], [127].

\(^{716}\) Re ESM I (Germany) [195]; Re ESM II (Germany) [161]-[162].

\(^{717}\) Aid Measures for Greece (Germany) [104] (emphasis added).
It should be noted here that it is not, from the outset, undemocratic for the budget-setting executive to be fettered by a particular fiscal policy.\textsuperscript{718} In \textit{Re ESM II}, the BVerfGE accepted that a commitment to a particular fiscal policy may be made through agreeing corresponding obligations under international law or EU law.\textsuperscript{719} The test for evaluating whether a fetter on budgetary autonomy amounts to an unconstitutional deprivation of sovereignty is whether control over that policy is relinquished, such that the fetter is not reversible by an equivalent act of the Bundestag in the future.\textsuperscript{720} The test of constitutionality applied is that ‘the democratic process remains open and that legal re-evaluations may occur on the basis of other majority decisions and that an irreversible legal prejudice to future generations is avoided.’\textsuperscript{721}

\subsection*{1.3.1.5 Unlawful Dispositions of Budgetary Sovereignty}

The second way the right to vote may be depleted of the substance of the power to rule is through the substantive disposition of the powers of the Bundestag itself.\textsuperscript{722} The budgetary powers so exercised by the Bundestag must not be depleted to such a degree that the right to make legal re-evaluations of budgetary policy under Articles 38 and 20BL is meaningless.\textsuperscript{723} The test in that regard is the same: A violation of the principle of democracy in its essential content will occur ‘if the German Bundestag relinquishes is parliamentary budget responsibility with the effect that it or a future Bundestag can no longer exercise the right to decide on the budget on its own responsibility.’\textsuperscript{724} In \textit{Aid Measures to Greece}, the BVerfGE held:

‘The relevant factor for adherence to the principles of democracy is \textit{whether the German Bundestag remains the place in which autonomous decisions on revenue and expenditure are made, even with regard to international and European commitments}. If decisions were made on essential budgetary questions of revenue and expenditure without the requirement of the Bundestag’s consent, or if supranational legal obligations were created without a corresponding free will of the Bundestag, Parliament would find itself in the role of merely re-enacting and could no longer exercise overall budgetary responsibility as part of its right to decide on the budget.’\textsuperscript{725}

\begin{footnotesize}
\begin{enumerate}
\item\textsuperscript{718} \textit{Re ESM II (Germany)} [168]-[169]: The budgetary rules in Articles 109, 115, and 143 of the German Constitution itself have been lawfully enacted in order to prevent the de facto loss of budgetary choice inherent in a bankruptcy.
\item\textsuperscript{719} \textit{Re ESM II (Germany)} [168]-[170]: ‘it is primarily for the legislature to weigh whether and to what extent … one should enter into commitments regarding future spending behaviour.’
\item\textsuperscript{720} \textit{Re ESM II (Germany)} [173] the court ruled that the ‘balanced budget rule’ under the TSCG (see Section 8.3.2.4) is not an unconstitutional fetter of Bundestag, because the treaty obligation can be reversed by an equivalent unilateral action in the future. See also: \textit{Aid Measures for Greece (Germany)} [124], [127]; \textit{Re ESM II (Germany)} [168]-[170].
\item\textsuperscript{721} \textit{Re ESM II (Germany)} [173].
\item\textsuperscript{722} \textit{Re ESM I (Germany)} [195]; \textit{Re ESM II (Germany)} [161]-[165]
\item\textsuperscript{723} Brunner (Germany) [172]; \textit{Re Lisbon (Germany)} [151], [186], [199]; \textit{Aid Measures for Greece (Germany)} [98], [100].
\item\textsuperscript{724} \textit{Aid Measures for Greece (Germany)} [121].
\item\textsuperscript{725} \textit{Aid Measures for Greece (Germany)} [124] (emphasis added). See also: \textit{Parliamentary Information (ESM & EPP) (Germany)} [114].
\end{enumerate}
\end{footnotesize}
First and most obviously, this means that the Bundestag cannot confer its formal competence in budgetary policy. A violation of the principle of democracy in its essential content would occur if ‘the type and amount of the levies imposed on the citizen were supranationalised to a considerable extent and thus the Bundestag would be deprived of its right of disposal.’

Second, Articles 38(1) and 20(2) cannot simply be got-around by signing over the common finances of the citizenry by blank cheque. This precludes depletions of the budgetary power through blanket commitments tantamount to accepting liability for decisions by free will of other states. The Bundestag may not transfer its budgetary responsibility through ‘imprecise authorisations’ or mechanisms with ‘incalculable burdens’ without prior mandatory Bundestag consent. In Aid Measures for Greece, the court held:

‘The Bundestag may not transfer its budgetary responsibility to other actors by means of imprecise budgetary authorisations. In particular it may not, even by statute, deliver itself up to any mechanisms with financial effect which – whether by reason of their overall conception or by reason of an overall evaluation of the individual measures – may result in incalculable burdens with budget relevance without prior mandatory consent, whether these are expenses or losses of revenue.’

Such automatic liability would be an impermissible structurally significant shaping or transformation of the German constitutional identity under Article 79(3) BL. This precludes financial liability under supranational accountability structures in which elections are neither free, direct nor equal, and where the Bundestag does not have a ‘decisive influence’ over the result. The court has explicitly precluded the ‘transfer union’ or ‘liability community’, in which budgetary dispositions are no longer determined by the autonomous exercise of the free will of the Bundestag in the manner required by Article 38 BL:

‘For this reason, no permanent mechanisms may be created under international treaties which are tantamount to accepting liability for decisions by free will of other states, above all if they entail consequences which are hard to calculate. The Bundestag must specifically approve every large-scale measure of aid of the Federal Government taken in a spirit of solidarity and involving public expenditure on the international or European level. Insofar as supranational agreements are entered into which by reason of their magnitude may be of structural significance for Parliament’s right to decide on the budget, for example by giving guarantees the honouring of which may endanger budgetary autonomy, or by participation in equivalent financial safeguarding systems, not only every individual disposal requires the consent of the

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726 Aid Measures for Greece (Germany) [126].
727 Re ESM I (Germany) [196]; Re ESM II (Germany) [163]. See also: Aid Measures for Greece (Germany) [105], [127], ‘If the Bundestag were to give indiscriminate authorisation in a substantial degree to guarantees, fiscal disposals of other Member States might lead to irreversible, possible massive, restrictions on national political legislative discretions.’
728 Aid Measures for Greece (Germany) [125].
**Bundestag:** in addition it must be ensured that sufficient parliamentary influence will continue in existence on the manner for which the funds are dealt with.729

Third, even a finite disposition must not be so large that the Bundestag is no longer able to dispose of its budget on its own responsibility.730 The right to vote under Article 38 would be equally meaningless if the Bundestag elected to give over the entire endowment of the citizenry, in one lump sum, as it would if it signed up to open-ended authorisation.

However, the BVerfGE exercises a high degree of curial deference with regard to the soundness of the budget where finite dispositions are concerned.731 The test applied to finite dispositions is a ‘manifest overstepping of ultimate limits’732 – i.e. whether the amount of the disposition is ‘of structural significance for parliament’s right to decide on the budget, for example by giving guarantees the honouring of which may endanger budget autonomy.’733

In monetary terms, the court has refrained from putting a number on this ‘ultimate limit,’ but it seems almost nothing short of a total disposal of the federal budget will do. In Aid Measures to Greece (Germany), the pledging of a sum ‘far greater than the largest federal budget item’ and ‘substantially exceeding half of the federal budget,’ did not deprive the Bundestag of its autonomy.734 In Re ESM I, the court stated that an upper limit would be overstepped if the expenditure ‘took effect in a way that budget autonomy, at least for an appreciable period of time, was not merely restricted but effectively failed.’735 In that case, budget commitments of €190,024,800,000 (approximately 50% of all central government expenditure)736 did not exceed this ceiling because it did not lead to a ‘complete failure of budgetary autonomy’ and did not fall outside the legislature’s margin of appreciation (so long as it did not constitute an open-ended commitment and did not deprive the Bundestag of the ability to shape the economic and social life of the state).737

1.3.1.6 Constitutional Limitations on Fiscal Sovereignty

Contrary to how Article 79(3) BL is sometimes interpreted by commentators, ‘constitutional identity’ does not mean that fiscal policy and all other constitutional powers listed in Re Lisbon (Germany) are absolutely and forever entombed at national level.738 It means that the list of powers in Re Lisbon (Germany) must be exercised in accordance with the machinery specified in Article 38

729 Aid Measures for Greece (Germany) [123], [128], [129], [137] [emphasis added]; Re ESM II (Germany) [164], [222]; Gauweiler I (Germany) [41].
730 Aid Measures for Greece (Germany) [107].
731 Re ESM I (Germany) [199]-[201]; Re ESM II (Germany) [168], [175].
732 Aid Measures for Greece (Germany) [131]; Re ESM II (Germany) [174].
733 Re ESM I (Germany) [198].
734 Aid Measures for Greece (Germany) [135].
735 Re ESM I (Germany) [200] (emphasis added). In Re ESM II (Germany) [174], [184], it held that Budgetary autonomy must not be ‘merely restricted’, but ‘effectively non-existent’ for ‘at least a considerable period of time’
737 Re ESM I (Germany) [240] (emphasis added); Re ESM II (Germany) [185] (emphasis added).
738 Kumm, 'Final Arbiter' (1999), 357-358; Preshova (2012), 283 (arguing that these principles are not absolute).
BL, or, if they cannot be so exercised, then the infringement on those competences must not be so severe that it violates the principles under Article 20(2) BL in their essential content. Put simply, it is the principle of constitutional democracy - not the formal power to, say, tax or imprison - which is inviolable. This implies that not every infringement of the list of competences in *Re Lisbon (Germany)* will violate the constitutional identity.\textsuperscript{739} There are three limits on the jurisdiction.

First, the words ‘particularly sensitive’ in *Re Lisbon (Germany)* indicate that not all ‘state-founding elements’ are included in that list, and not all intrusions on that list will violate the constitutional identity of Germany.\textsuperscript{740} Powers that are not ‘particularly sensitive’ for self-determination do not need to be exercised according to the formula specified in the constitution.\textsuperscript{741} It is only if the power is both particularly sensitive and structurally compromised that the identity jurisdiction triggered. In *Re Lisbon*, for example, the expansion of QMV under the Lisbon Treaty passed that test, because the EU’s conferred powers were controlled by the German constitutional organs, and the powers under the umbrella of Article 20(1)-(2) were still exercised in accordance with Article 38(1).\textsuperscript{742}

Second, the enumeration of constitutional identity competences in *Re Lisbon (Germany)* does not mean that those competences can never be conferred; it means that they cannot be conferred or exercised in a manner which breaks the ‘chain of legitimation’ under the German constitution.\textsuperscript{743} There is a difference. For example, the possibility of automatic budgetary liability under the ‘capital calls’ provisions of the ESM Treaty did not violate Article 38 BL, because the voting formula gave the German government (and, by extension, the Bundestag) an effective veto over each new disposition to the ESM.\textsuperscript{744} Similarly, in *Brunner (Germany)* monetary policy was lawfully conferred on the ECB because the conditions which apply to the ECB under Article 119 and 127 TFEU are the same as those that apply to the *Bundesbank* under Article 88 BL, so no automatic liability could occur.\textsuperscript{745} The essential staple is that conferral is permitted, as long as this does not change the content of the guarantee itself.\textsuperscript{746}

Third, not all encroachments on ‘state founding’ powers will constitute a violation of democracy in its essential content. As Grimm suggests, ‘the list fulfils the function of warning sign: touching these

\textsuperscript{739} Dieter Grimm, 'Defending Sovereign Statehood Against Transforming the Union Into a State' (2009) 5 EuConst 369.

\textsuperscript{740} See: Preshova (2012), 283 (arguing that these principles are not absolute).

\textsuperscript{741} See: *Re Lisbon (Germany)* at [242]-[245], [327] ‘As long as European competences are ordered according to the principle of conferral…. the democracy of the [EU] cannot, and need not, be shaped in analogy to that of a state.’

\textsuperscript{742} *Brunner (Germany)* [33]; *Re Lisbon (Germany)* [250]-[253] (‘the Treaty of Lisbon does not alter the fact that the Bundestag as the representative body of the German people is the focal point of an intertwined democratic system.’)

\textsuperscript{743} *Re Lisbon (Germany)* [237]-[238]: ‘The development of the European Union in respect of a transfer of sovereign powers, institutions and decision-making procedures must correspond to democratic principles (art.23.1 Basic Law).’

\textsuperscript{744} *Re ESM I (Germany)*; *Re ESM II (Germany).*

\textsuperscript{745} *Brunner (Germany).*

\textsuperscript{746} The BVerfGE has taken the same approach to human rights, where the BVerfGE in *Solange II (Germany)* and *Bananas (Germany)* agreed not to control each act EU act for human rights ‘so long as’ it afforded a level of protection equivalent to the Basic Law. Cf: *EAW (2735/14) (Germany).* As Kumm, 'Final Arbitre' (1999), 379 observes: that the BVerfGE has jurisdiction ‘only to the extent that there are no sufficient safeguards instituted on the European level to prevent an unjustified usurpation of legislative power.’
matters implies a danger to the identity of the Member States. This will not be the case unless the decision is reversible by an equivalent action by the Bundestag and the degree of the infringement is of structural significance to Parliament’s right to decide on the budget. So, for example, in Re ESM (Germany), the court applied a test of proportionality and a margin of discretion to infringements of revenue and expenditure autonomy. The Bundestag could dispose of huge sums - approximately 50% of all central government expenditure – without this constituting a complete failure of budgetary autonomy.

Taken together, the essential thrust of the German constitutional identity jurisdiction is this: In those areas touched by the eternity clause, state power must be exercised in accordance with the formula for democracy in Articles 38, 20 and 79(3) BL, and the entire chain of legitimation between the voter and the exercise of the state power must be intact. This may be secured by the retention of competences at national level, or by allowing the Bundestag to exert ‘decisive influence’ at EU level, but at all ends, a majority of the voters in Article 38(2) BL, voting in accordance with the formula in Article 38(1)(i), must possess the substance of the power to rule through an elected Bundestag that is free of other directed-ness and the master of its decisions (Articles 38(1)(ii), 20, and 79(3)).

1.3.2 Price Stability and the Stability Community

The second constitutional boundary pursued in this thesis consists of the principles of price stability, fiscal discipline and sustainable balance of payments set forth in the mandate for EMU under Article 119 TFEU. Price stability is the constitutional apogee of the federal design examined in this chapter - the ‘sine qua non for economic and monetary union.’ In the realm of monetary policy, under Articles 119(2) TFEU, 127(1) TFEU, and Articles 2-3 and 17 to 24 of the Statute of the ESCB, all of the activities and tasks conferred on the Union are confined to the ECB’s instruments and tied to the objective of price stability. It is this condition that informs the entire system of economic and

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747 Grimm, 'Defending Sovereign Statehood' (2009). In Re Honeywell (BVerfGE) [50], for example, the court held that violations of the German constitution may occur in any context, but ‘weigh particularly heavily’ where it concerns a feature of constitutional identity.

748 Re ESM II (Germany) [235].

749 Re ESM I (Germany) [196]; Re ESM II (Germany) [163].

750 Re ESM I (Germany) [240]; Re ESM II (Germany) [185].

751 Art 119(3) TFEU: ‘These activities of the Member States and the Union [Economic and Monetary Policy] shall entail compliance with the following guiding principles: stable prices, sound public finances and monetary conditions and a sustainable balance of payments.’

monetary policy competences in the Treaty, and it is to this objective that all of the substantive provisions on economic policy in Articles 121-126 TFEU are attuned.

In the realm of economic policy, this manifests in the principles of budgetary discipline and sustainable balance of payments – a dual requirement referred to herein as ‘fiscal discipline.’ It is this principle which informs the legal architecture of fiscal federalism under Articles 119-126 TFEU. Those provisions enshrine the economic antecedents of price stability in a monetary union by installing a legal budget constraint and mechanisms for market discipline in the Treaties. The economic design of this legal architecture is discussed in Chapter 2, but for present purposes it is sufficient to remark that this fiscal discipline, too, reflects a (national) constitutional boundary of the European legal order: According to the BVerfGE, the fundamental principles of the Stability Community (Stabilitätsgemeinschaft) are a constitutional stipulation of the EU’s conferred competence in economic coordination and monetary policy. A development contrary to that mandate would violate the conditions subject to which monetary policy was conferred, mandating Germany to withdraw from the monetary union. As stated by the BVerfGE in Brunner v EU Treaty:

‘Article [119 TFEU] sets up the guiding principles for member-States’ activities the maintenance of price stability, sound public finances and monetary conditions, and a sustainable balance of payments. This conception of the currency union as a community based on stability is the basis and subject-matter of the German Act of Accession. If the monetary union should not be able to develop on a continuing basis the stability present at the beginning of the third stage within the meaning of the agreed mandate for stabilization, it would be abandoning the Treaty conception.’

Price stability and the Stabilitätsgemeinschaft has been linked by the BVerfGE to the independence of the ECB, the prohibition on monetary financing, the no-bailout clause, and the Stability and Growth Pact. Monetary policy instruments which are not based primarily on price stability must be ultra vires EU law, and systems of liability outside this mandate will constitute a violation of fiscal sovereignty. In particular, the BVerfGE has warned that the principles of Stabilitätsgemeinschaft would be violated - in turn violating Articles 20 and 79(3) of Germany’s constitutional identity - if

753 European policy documents use ‘economic policy’ to describe government fiscal policy in this context. This thesis uses both economic policy and fiscal policy interchangeably to describe any policies which refer to the use of government revenue, debt or expenditure to influence the economy.

754 Brunner (Germany) [80]-[89]; Aid Measures for Greece (Germany) [129]; re ESM I (Germany) [203]; Gauweiler I (Germany) [32].

755 Brunner (Germany), at [89].

756 Brunner (Germany) [86], [89], [90] (emphasis added).

757 Art 130 TFEU. See: Brunner (Germany) [96]; re ESM I (Germany) [203].

758 Art 123 TFEU. Brunner (Germany) [89]; Gauweiler I (Germany) [32]; Aid Measures for Greece (Germany) [204].

759 Art 125 TFEU. Aid Measures for Greece (Germany) [129]; re ESM I (Germany) [203].

760 Art 121, 126 TFEU. Aid Measures for Greece (Germany) [129]. Re ESM I (Germany) [203].
the Union should become a ‘liability community’ through the ‘direct or indirect communitarisation of state debts.’

As stated in Re ESM (Germany):

‘The current programme of European integration designs the monetary union as a stability community. As has been repeatedly emphasised by the [BVerfGE], this is the essential basis of [Germany’s] participation in the monetary union. Not only with regard to currency stability, the treaties are parallel to the requirements of Article 88(2) of the basic law … which makes compliance with the independence of the [ECB] and the primary objective of price stability permanent constitutional requirements of a German participation in the monetary union; further central provisions …. also safeguard the constitutional requirements in European law. This applies in particular to the prohibition of monetary financing… the prohibition of accepting liability (bailout clause) and the stability criteria for sound budget management.’

In order for any architecture of fiscal federalism to be constitutional, it must not only conform to the allocation of competences under Articles 2(3), and 5(1) TFEU - it must fulfil the substantive conditions for economic and monetary policy in Articles 119-127 TFEU.

1.3.2.1 Price Stability

Under Articles 3(c), 119(2), and 127 TFEU, the ECB’s monetary policy competence and all of its instruments are bound to the primary objective of price stability. This, too, is a restriction carved directly from the German Constitution. Article 88 BL [Federal Bank] states:

‘The Federation establishes a note-issuing currency bank as the Bundesbank. Its tasks and powers can, in the context of the European Union, be transferred to the European Central Bank which is independent and primarily bound by the purpose of securing stability of prices.’

This imposes a constitutional safeguard clause which allows the conferral of competence on the ECB constitutional only in so far as it remains independent and bound to the primary objective of price stability. The limits of the EU’s monetary policy competence are therefore limits which apply to the

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761 Aid Measures for Greece (Germany) [129], [137]. See also Gauweiler I (Germany) [41]: ‘independence of the national budgets, which opposes the direct or indirect common liability of the Member States for government debts, is constituent for the design of the monetary union.’

762 Re ESM I (Germany) [203].

763 Art 119(2) TFEU states: ‘As provided in the Treaties and in accordance with the procedures set out therein, these activities shall include a single currency, the euro, and the definition and conduct of a single monetary policy and exchange-rate policy the primary objective of both of which shall be to maintain price stability and, without prejudice to this objective, to support the general economic policies in the Union…’ Art 127(1) TFEU states: ‘The primary objective of the European System of Central Banks (hereinafter referred to as ‘the ESCB’) shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union. The ESCB shall act… in compliance with the principles set out in Article 119.’

764 See: Brunner (Germany) [85]; Re ESM I (Germany) [203].

765 Art 88 Grundgesetz (2013) (sentence inserted by the 38th Amendment to the Constitution (21.12.92). This is in turn linked to the right to property under Art 14 of the German Basic Law, which guards against the expropriation of savings through inflation. Under Art 73(1)(4) BL, the Bund has ‘exclusive power to legislate in … currency, money and coinage, weights and measures, as well as the determination of standards of time.'
**Bundesbank** under the German constitution and are impressed upon the act of conferral itself. Unlike the Bank of Canada,\(^{766}\) the Bank of England,\(^{767}\) or the US Federal Reserve,\(^{768}\) for example, the ECB can have no mandate for financial stability - not because the EU legislator would not allow it, but because the German constitutional order would not allow it. The EU simply hasn’t been given any broader competence, because no such competence exists under the Basic Law.

Since *Brunner v EU Treaty (Germany)*, the primacy of price stability under Articles 119 and 127 TFEU has been central to the constitutionality of Germany’s ongoing participation in the EMU under Article 79(3)BL.\(^{769}\) In *Gauweiler (Germany)*, for example, the BVerfGE emphasised that:

‘This limitation of democratic legitimation [of conferral of monetary policy], which is derived from the voters in the Member States, affects the principle of democracy but is compatible with Art.79(3) as [...] envisaged in Art.88, which was made with a view to the European Union, allows a transfer from the Bundesbank to a European central Bank if it meets the “strict criteria of the Maastricht Treaty and the Statute of the European System of Central Banks and the priority of a stable currency”.’\(^{770}\)

Unlike many of the other objectives of the Union, it is the actual attainment of price stability to which Member States and the Union are bound under Article 119(3) TFEU.\(^{771}\) In *Brunner (Germany)*, the BVerfGE held that the various legal enshrineds of price stability in the Treaty satisfied the price stability obligation under the constitution *in so far as* they were realised.\(^{772}\) The court noted, for instance, that ‘The Union Treaty governs the monetary union as a community which is permanently obliged to maintain stability and, in particular, to guarantee the stability of the value of the currency.’\(^{773}\) In that case, participation in EMU was held to be constitutional because the legal framework for price stability in the Treaty was sufficient for its attainment in principle, however, as the court emphasised, the Treaties ‘do not prevent withdrawal from the Community in the event of the community based on stability failing to materialise.’\(^{774}\) As stated by the Bundestag resolution on the Act of Accession presented to the BVerfGE: ‘The future European currency must be, and remain, as stable as the German Mark.’\(^{775}\)

\(^{766}\) Preamble, Bank of Canada Act, R.S.C. 1985 c.B-2; Section 11.


\(^{768}\) Section 2A, Federal Reserve Act (ch. 6, 38 Stat. 251, enacted December 23, 1913, 12 U.S.C. ch. 3).

\(^{769}\) *Brunner (Germany)* [80], [89].

\(^{770}\) *Gauweiler I (Germany)*.

\(^{771}\) See, e.g., Commission, ‘Towards a Stability Pact’ II/011/96-EN, 10 January 1996, 9 ‘As Art 3(a) [EC] (now 119 TFEU) contains a direct reference to … the objectives of the Treaty, it follows that … the principle of sound public finances [has] general application. This is reaffirmed in Art 102a and in practical terms is spelled out in Articles 103, 104, 104a, 104b and 104c (and the associated Protocol on the excessive deficit procedure).’

\(^{772}\) *Brunner (Germany)* [85].

\(^{773}\) *Brunner (Germany)* [89] [emphasis added].

\(^{774}\) *Brunner (Germany)* [89] holding that the legal framework of price stability in the Treaty was sufficient to satisfy Article 88 BL as a matter of principle, and so the possibility of factual failure was held to be ‘insufficiently plausible.’

\(^{775}\) BTDrucks. 12/3906; Sten. Ber 12/126 p. 1087, as cited by the BVerfGE, in *Brunner (Germany)*, 70.
It should be emphasised here that Article 88 BL is not, in and of itself, part of the German constitutional identity. An ordinary breach of that provision will fall to BVerfGE’s ultra vires review jurisdiction, (see Section 1.2.1) under which the BVerfGE will not strike down an EU act unless it is manifest that EU acts ‘have taken place outside the transferred competences’ and the breach is ‘structurally significant.’

However, Article 88 does shield other constitutional provisions which are linked to Article 79(3) BL. These are, specifically, the right to property (which protects against the expropriation of money-holders through inflation); and constitutional democracy (which protects the constituent power against unauthorised or open-ended financial dispositions).

The reason for this is that, unlike federal banks in Canada, the US or Switzerland, ECB monetary programmes are inherently redistributive. When the US Federal Reserve conducts bond purchase operations, for example, it purchases the high-quality federal bonds of a government that is backed by all citizens directly, and which all citizens control directly at the ballot box. The bonds are not guaranteed by any state governments, and so ‘The Fed is not bailing out a cash-strapped country [and] distributing risks among the taxpayers with an excellent credit rating.’ Purchases of public sector securities ‘do not lead to redistributonal effects among the individual states of the US.’ In the European Union, by contrast, deliberately targeting the bonds of Greece uses taxpayer contributions from all Member States to assume risks incurred by one Member State and, as the Bundesbank states: ‘Monetary policymakers have no authorisation to redistribute such risks or burdens among the taxpayers of various euro-area countries.’

For this reason, as asserted by the BVerfGE in Gauweiler I (Germany) and Gauweiler III (Germany), a violation of Articles 123 or 127 TFEU will not only be ultra vires Article 88 BL, but may constitute a structurally significant infringement of constitutional identity.

776 Re Honeywell (BVerfGE) [40]-[46],[51]; EAW (2735/14) (Germany) [I](2)(c). The BVerfGE will first submit a preliminary reference to receive an authoritative interpretation of a suspected ultra vires act, and, if found, EU institutions are then afforded a ‘tolerance of error’. In order to be manifestly in violation of competences, the impugned act must be ‘sufficiently qualified’, defined by reference to the CJEU’s case law on ‘sufficiently serious’ breaches of EU law. That is, whether the Community institution concerned manifestly and gravely disregarded the limits on its discretion.’ See: Case C-472/00 Commission v Fresh Marine [2003] ECR I-7541; [2003] 2 CMLR 39, [26]. A breach will be structurally significant where it is ‘highly significant in the structure of competences [with] regard to the principle of conferall and to the binding nature of the statute under the rule of law.’ Aid Measures for Greece (Germany) [99]-[100]. On the question of ‘cumulative encroachment’, where multiple small encroachments add up to a structural violation, see: Grimm, ‘Defending Sovereign Statehood’ (2009); Kaiser (2010).

777 On Art 88 BL, see: Harold James, Making the European Monetary Union (Princeton University Press 2014).

778 Gauweiler I (Germany); Gauweiler III (Germany). See Art 14, in conjunction with Arts 1 and 79(3) Grundgesetz (2013). As Pernice, ‘Multilevel Constitutionalism’ (1999), 721 observes: ‘It is from now on a European institution which has been vested with the power and responsibility to safeguard the money-owners fundamental right to private property.’


781 Deutsche Bundesbank (2011) 165.

782 Gauweiler I (Germany); Gauweiler III (Germany).
1.3.2.2 Budgetary Discipline and Sustainable Balance of Payments

In economic policy, the Stabilitätsgemeinschaft manifests in the principles of fiscal discipline under Articles 119(3) and 121-126 TFEU. The architecture constructed for the achievement of these principles is examined in Chapter 2, but it suffices here to state that entry into the final (third) stage of EMU is contingent on the attainment of certain empirical indicators and fiscal rules governing public finances and economic stability.

As will be shown Chapter 2, the purpose of these principles is primarily economic. However, these rules also entrench principles which are at the heart of constitutional identity, and, what is important for this thesis, is that they are constitutional stipulations of Germany’s participation in the EMU. As stated in Re ESM (Germany):

‘The current programme of European integration designs the monetary union as a stability community. As has been repeatedly emphasised by the [BVerfGE], this is the essential basis of [Germany’s] participation in the monetary union… This applies in particular to the prohibition of monetary financing… the prohibition of accepting liability (bailout clause) and the stability criteria for sound budget management.’

It should be emphasised here, however, that while these provisions safeguard the German constitutional identity, they are not direct manifestations of it (unlike the limits of competence in economic policy). As was made clear in Re ESM Treaty, ‘not every single manifestation of the stability community is guaranteed by [Article 20 BL] in conjunction with art.79(3).’ Violations are first and foremost a matter of ultra vires review, not constitutional identity, unless it also violates the tests set out in Section 1.3.1 of this thesis. In practice, it may make no difference how many lines are crossed, since, as noted in Gauweiler v Bundesbank, a violation of the stabilitätsgemeinschaft with regard to the automatic liability of Germany will also lead to a violation of Articles 38, 20 and 79(3)BL and the consequences of both ultra vires and identity review are invalidity. However, unless the tests in Section 1.3.1 are also met, the primary applied here is different: It is whether the Union violated the ‘community based on stability (stabilitätsgemeinschaft) [that] is the basis and subject-matter of the German Act of Accession… within the meaning of the agreed mandate for stabilisation.’

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783 See Section 2.2.2. Bishop, Damrau and Miller (1989), 1: ‘In purely economic terms, there are probably two principal requirements for such a [monetary] union to be credible and permanent: Fiscal prudence – to guard against inflation; and Internal balance – to prevent weaker countries from becoming impoverished.’

784 Brunner (Germany) [86], [89], [90].

785 Re ESM I (Germany) [203]-[205]: ‘In this context, an essential element of safeguarding the constitutional requirements resulting from art.20(1) and (2) in conjunction with art.79(3) of the Basic Law in European Union Law is the prohibition of monetary financing by the European Central Bank.’ See also: Re ESM II (Germany) [166]-[171].

786 Re ESM I (Germany) [204].

787 Gauweiler I (Germany). NB: Kompetenz-kompetenz is anyways a consequence of constitutional identity.

788 Brunner (Germany) [90].
1.4 Conclusions: Permanent Constraints on European Fiscal Federalism

The principal conclusion to be derived from this analysis is that the boundaries extracted in this chapter are real, they are permanent, and, for the architects of fiscal federalism, they are dangerous: Constitutional identity and *ultra vires* review jurisdictions exert real positive force on the boundaries of EU law. Constitutional courts have stated (and demonstrated) that nascent machineries of fiscal federalism will be invalidated if they trespass on constitutional fiscal sovereignty or abrogate the *Stabilitätsgemeinshaft*, and this study must take them at their word. This conclusion derives from three cumulative analyses:

[1.1] First, the European Union is a ‘federation of states,’ possessed of a top-down federal hierarchy with a legal supremacy greater than any individual expression of Member State sovereignty on one hand, yet on the other hand derived from the confederate authority of national orders which sanction its reach. However the reality that concerns this thesis is that, whether one adopts a Kelsenian or a pluralist approach, national constitutional courts remain the reference point for validity in national legal systems.  

This is demonstrated by a growing catalogue of cases where national courts *in fact* invalidated the effects of ECJ rulings, and these decisions were *in fact* taken as authoritative statements of law by the legal system.

[1.2] In the European Union, national constitutional orders impose two types of limit on the EU’s conferred powers: 

[1.2.1] First, that they have the jurisdiction to assert, through Treaty ratification and *ultra vires* review, what powers they have and have not conferred on the Union - the so-called *kompetenz-kompetenz*. 

[1.2.2] Second, they assert that their own ‘constitutional identity’ jurisdictions determine the absolute limits of Union law. This chapter finds that these assertions are a valid constitutional, normative and positive description of the limits of the EU legal order. In all twenty-seven Member State constitutions surveyed in this thesis, no state institution may validate an exercise of public power that is not democratically legitimated in the manner specified in the constitution. All, including the most basic among these jurisdictions, preclude a disposition of the *Kompetenz-kompetenz*. The EU cannot therefore exceed its own competences, or depend on legal machineries placed beyond them. The most developed of these jurisdictions, such as the German ‘eternity’ clause, entrench a specific formula for democracy: they require that *x* powers can only be exercised by *y* institutions according to *z* formula, and these components themselves are not amendable.

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789 MacCormick, 'Beyond the Sovereign State' (1993), 3: ‘if [the national constitutional authority] did in future command something incompatible with Community obligations, while also commanding that this and subsequent commands should be deemed binding regardless of conflict with … Community law, such a command would be obeyed by judges, officials, and citizens in the UK, and would in that sense be valid law for us, regardless of anyone else’s view.’

790 For discussion on the concept of *Kompetenz-kompetenz*, see: Lock (2010). *Re Lisbon (Germany)* [209], [215].

791 For other authors which identify these same limits, see: Huber (2014), 11-14, which states: ‘In the end there are two limits to European integration derived from national constitutional law: (a) the national or constitutional identity on the one hand and (b) the programme of integration on the other (b). They both limit the precedence of EU law.’

792 See: Section 1.2.1.
Under these jurisdictions, two substantive constitutional boundaries which will bear upon any model of European fiscal federalism:

[1.3.1] The first is fiscal sovereignty. In so far as the Union is founded upon the principles of conferral, it can have no powers other than what the Member States have given it, what the Member States have given it is limited by their own constitutional identities.\(^{793}\) Not only has economic policy not been conferred on the Union, but, according to the BVerfGE, it cannot ever be so conferred without abrogating the ‘Democratic State’ (Article 20) and violating the ‘eternity clause’ (Article 79(3)) of the 1949 German Basic Law.\(^{794}\) Numerous other constitutional courts have drawn similar boundaries around fiscal sovereignty.\(^{795}\) Any machineries of public economics must remain within the allocation of competences and comply with the tests set out by Member State constitutional courts under these jurisdictions, or they will not take effect in the legal system.\(^{796}\) The tests applied by this thesis in that regard are:

[1.3.1.4] A restriction on budgetary sovereignty must not ‘fetter the budget legislature to such an extent that the principle of democracy is violated’, i.e., ‘with the effect that it or a future Parliament can no longer exercise the right to decide the budget on its own’;\(^{797}\) and

[1.3.1.5] A disposition of budgetary sovereignty must not compromise the principle that ‘the [national] Parliament remains the place in which autonomous decisions on revenue and expenditure are made’;\(^{798}\) and

[1.3.1.6] The decision must reversible by a unilateral equivalent action by the Parliament in the future and the degree of the infringement must not be of structural significance to the Parliament’s right to decide on the budget.\(^{799}\)

[1.3.2] The second constitutional boundary is comprised of the fundamental guiding principles of price stability and fiscal discipline set forth in the mandate for the construction of EMU under Article 119 TFEU.\(^{800}\) According to the BVerfGE, the fundamental principles of the Stabilitätsgemeinschaft

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\(^{793}\) See, e.g., Germany: Re Lisbon (Germany) [221]. Denmark: Carlsen (Denmark) [13]. Poland: ESM & TSCG (Poland) [6.3.1]. Ireland: SPUC v Grogan I (Irish Supreme Court), 769. Spain: Maastricht (Spain) [4]. UK: Thoburn v Sunderland CC (UK) [69]. France: Re Maastricht I (France) [43]; Re Maastricht II (France) [31]-[35], [42]-[43].

\(^{794}\) Brunner (Germany) [91]; Re Lisbon (Germany) [228], [232]; Aid Measures for Greece (Germany) [107], [127]; Re ESM I (Germany) [193], [196]; Re ESM II (Germany) [161]-[165]; Gauweiler I (Germany) [28].

\(^{795}\) France: Re Maastricht I (France) [43]; Re Maastricht II (France) [31]-[35], [42]-[43]; TSCG (France) [16]. Ireland: Croissy (Ireland), 783; Pringle I (Ireland Supreme Court) [8.14]; Collins (Ireland) [95]-[98]. Poland: Lisbon (Poland), 200; ESM & TSCG (Poland). Estonia: ESM (Estonia) [105], [106], [144]. Czech Republic: Lisbon I (Czech Republic) [91], [93]. Spain: Catalonia v State Solicitor DTC 134/2011 (Spain) [8](a). Austria: ESM (Austria) [104]-[105]. Finland: Opinion on the Six Pack (Finland); Opinion on the Six Pack II (Finland); Six Pack III (Finland).

\(^{796}\) See: Section 1.3.1.1. For a comparative account of the development of German review of EU law, see: Kokott (1998).

\(^{797}\) Aid Measures for Greece (Germany) [104] and Re ESM I (Germany) [195]; Re ESM II (Germany) [161].

\(^{798}\) Aid Measures for Greece (Germany) [124]. See also: Parliamentary Information (ESM & EPP) (Germany) [114].

\(^{799}\) Re ESM II (Germany) [173]: The test is that ‘the democratic process remains open and that legal re-evaluations may occur on the basis of other majority decisions and that an irreversible legal prejudice to future generations is avoided.’

\(^{800}\) Art 119(3) reads: ‘[The econimic and monetary union] shall entail compliance with the following guiding principles: stable prices, sound public finances and monetary conditions and a sustainable balance of payments.’
(Stability Community) are a constitutional stipulation of the EU’s conferred competence in economic coordination and monetary policy. While these principles are not in themselves part of the ‘constitutional identity,’ the architecture of the Stabilitätsgemeinschaft indirectly shields other principles of the Democratic State (Article 20 BL) and human dignity (Article 1 BL) which are part of the constitutional identity shielded by the German ‘eternity clause’ and are not amendable, lex lata or lex ferenda. Here, it is not so much that a failure of constant adherence to 2% inflation or 60% of GDP in debt is manifestly incompatible with the European legal order and will immediately entail a declaration of invalidity or withdrawal from EMU. Rather, it is that systems which are not constructed upon these principles are manifestly incompatible with the European legal order. So, for example, as a matter of public economics, a model of fiscal federalism that fails to incorporate budgetary discipline means inflation, debt-mutualisation or centralisation, and this offends the right to property (Article 14 BL) and the right to vote (Article 38 BL) which are part of the constitutional identity in conjunction with Article 1 BL (Human Dignity) and Article 20 BL (the Democratic State) and are not amendable under ‘eternity clause.’

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801 This is the essential basis by which Germany participates in the monetary union: Brunner (Germany) [80]-[89]; Aid Measures for Greece (Germany) [129]; Re ESM I (Germany) [203]; Gauweiler I (Germany) [32].
802 This is so as a result of the right to property under Art 14 of the German Basic Law, which guards against the expropriation of savings through inflation, and is incorporated into Art 1 (Human dignity) shielded from amendment by the German ‘constitutional identity’ clause (Art 79(3) BL).
803 It also shields the right to property (Art 14 BL) which guards against the expropriation of savings through inflation, and is incorporated into Art 1 (Human dignity) shielded from amendment by the ‘eternity’ clause (Art 79(3) BL): Gauweiler I (Germany); Gauweiler III (Germany).
804 Brunner (Germany) [56].
2. The Maastricht Architecture of European Fiscal Federalism
2. Introduction to the Economic and Legal Construction of EMU

Having identified the underlying constitutional principles of price stability and fiscal discipline, Chapter 2 examines the economic architecture in Title VIII of the TFEU in order to identify the basic principles of fiscal federalism theory inscribed in the Treaty for their achievement. It identifies where the constitutional boundaries identified in this thesis inhere in the legal design of EMU, and explains the basic precepts of public economics enshrined in the European economic constitution since Maastricht. It proceeds in three parts:

Section 2.1 begins by briefly explaining the economic and legal history of EMU, and familiarising the reader with the main technical inputs for the travaux préparatoires at Maastricht.

Section 2.2 conducts the task of identifying where the constitutional boundaries pursued in this thesis inhere in the construction of EMU under Title VIII, ‘Economic and Monetary Policy’ of the TFEU. Member State fiscal sovereignty is shown to inhabit the allocation of competences in economic policy under Articles 2(3), 5(1) and 119-126 TFEU. The substantive principles of price stability, sound public finances and a sustainable balance of payments, are shown to inhere in the fundamental guiding principles of EMU (Article 119 TFEU) and the entirety of the economic and legal design of Title VIII of the TFEU. As this thesis is concerned with fiscal federalism, it is primarily concerned with the architecture of budgetary discipline and a sustainable balance of payments – the dual requirement referred to herein as the condition of ‘fiscal discipline.’

Section 2.3 then sets out the technical model of European fiscal federalism inscribed in the Treaties at Maastricht. The model described in this Chapter is comprised of three interlocking mechanisms that comprise a single machinery for fiscal discipline.  

805 As Adamski, ‘(Misguided) Constitution’ (2013), 62 observes: fiscal sovereignty is the ‘implicit crux’ of the European economic constitution. Art 2(3) TFEU states that ‘The Member States shall coordinate their economic and employment policies within arrangements as determined by this Treaty, which the Union shall have competence to provide,’ and Art 5(1) TFEU states that, ‘The Member States shall coordinate their economic policies within the Union’ and that ‘the Council’ shall adopt measures to that end. Art 2(5) states that ‘In certain areas and under the conditions laid down in the Treaties, the Union shall have competence to carry out actions to support, coordinate or supplement the actions of the Member States, without thereby superseding their competence in these areas.’

[2.3.1] The Prohibition on Financial Assistance is comprised of an interlocking constellation of provisions governing access to public finance under Articles 123-125 TFEU (ex 101-103 EC). The effect of this interlocking framework is that, outside of the narrow emergency clause provided under Article 122(2) TFEU, Member States are unable to access finance other than under the disciplines of the markets: Article 123 prohibits the Member States from obtaining financial assistance from the ECB; Article 124 prohibits the Member States from obtaining privileged financing from financial institutions; and Article 125 TFEU prohibits the Member States from obtaining financial assistance from each other. This integrative structure functions to cut off access to all non-market sources of public finance.

[2.3.2.1] The Multilateral Surveillance Procedure (MSP) (Article 121 TFEU, ex 99 EC), emerged in 1990 as a surveillance mechanism to ‘ensure a high degree of convergence of economic performances between member States through closer coordination of economic policies’ during Stage I of the glide-path to EMU. In 1997, this was instrumentalised and extended into the third (completed) stage of EMU as the ‘preventative arm’ of Stability and Growth Pact (SGP) - a rule-based multilateral framework for identifying and disciplining profligate governments.

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807 This was confirmed by the ECJ in Pringle v Ireland [135], which held that the purpose of the ‘no bailout’ rule is to entrench, in primary EU law, the principle of individual fiscal responsibility and to expose individual Member States to market discipline in the exercise of their fiscal policy. See also: Gauweiler II (Opinion of AG Cruz-Villalon) [191]. See further: Commission of the EEC, 'Economic and Monetary Union' (Communication) SEC (90) 1659 (21 August 1990); Commission of the EC, 'Economic and Monetary Union: The Economic rationale and Design of the System' (Brussels 22 March 1998) <http://europa.eu/rapid/press-release_IP-90-231_en.htm> accessed 10 February 2014; Monetary Committee, 'Economic and Monetary Union Beyond Stage I: Orientations for the preparation of the intergovernmental conference' [1990] Europe Documents No 1609 (3 April 1990) [4]; Committee of Central Bank Governors of the EEC, Report by the Chairmain to the Informal ECOFIN Council Meeting on Economic and Monetary Union Beyond Stage One (26 March, 1990), 2. For comment: Palmstorfer (2012); Vestert Borger, 'The ESM and the European Court's Predicament in Pringle' (2013) 14 German LJ 113, 119; Rene Smits, 'The Crisis Response in Europe’s Economic and Monetary Union: Overview of Legal Developments' (2015) 38 Fordham Int'l Law J 1135, 1141.

808 Gauweiler II (Opinion of AG Cruz-Villalon) [131]. See also: Ruffert (2011), 1786; Louis (2010), 977, 983.


810 The SGP has gone through several iterations pursuant to amendments in 2005 and 2011, which are discussed in Chapter 6. This section is concerned with the SGP as originally enacted in 1997. The SGP was enacted into law on 7 July 1997 by: Resolution of the European Council on the Stability and Growth Pact [1997] OJ C 236/1; Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies [1997] OJ L 209/1; Council Regulation (EC) No 1467/97 of 7 July 1997 on the speeding up and clarifying the implementation of the excessive deficit procedure [1997] OJ L 209/6. As it remained in effect until 2011, the MSP relied upon a non-binding ‘soft law’ procedure for multilateral surveillance and coordination known as the Open Method of Coordination (OMC), designed to support market discipline by ensuring that imbalances do not accrue hidden to markets, electorates and stakeholders. On the OMC as it was envisioned and enacted at Maastricht, see: Lastra (2006), 248. On the twin-pillar structure of economic & fiscal policy, see: Fabian Amtenbrink and Jakob De Haan, 'Economic Governance in the European Union: Fiscal Policy Discipline versus Flexibility' (2003) 40 CMLR 1075.
[2.3.2.2] **The Excessive Deficit Procedure (EDP)** (Article 126 TFEU, ex 204 EC), emerged out of the convergence criteria for entry to the EMU, and was instrumentalised alongside its MSP counterpart in 1997 as the ‘corrective arm’ of the SGP. It provides for several enforcement mechanisms to be visited upon profligate Member States which incur ‘excessive deficits,’ defined as deficits exceeding 3% of GDP or gross debts exceeding 60% of GDP. The Maastricht model follows a blueprint for fiscal federalism that is well-established in theory as the ‘ideal type’ or ‘market-preserving’ federalism (see Chapter 7) and is well-evidenced in history, visible in the autonomous credit ratings of Swiss Cantons, Canadian Provinces and American States. The Maastricht architecture is based on two principles: Fiscal sovereignty - Member States have complete fiscal sovereignty, left to their devices outside the EU legal order and responsible for their own budgetary policies; and hard budget constraints and market discipline for the achievement of price stability and fiscal discipline. In short, the model is one of ‘fiscal decentralization constrained by financial markets and rules without financial solidarity.’ As AG Cruz-Villalón so put it in *Gauweiler v Bundesbank*:

‘Articles 123-125 TFU … lay down strict prohibitions of the financing of States, whether by means of monetary financing measures or by means of transfers between Member States. Those prohibitions confirm that monetary union … seeks to maintain financial stability, for which purpose it is based on a principle of fiscal discipline and the principle that there is no shared financial liability (the ‘no-bailout’ rule).’

2.1 **Foundations of European Economic & Monetary Union**

Since the late nineteenth century, successive generations of European liberal economists have argued for the achievement of two conditions for the optimal allocation of production factors in Europe - one economic and one monetary: The removal of barriers to trade and currency convertibility. In

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811 The SGP was enacted into law on 7 July 1997 by two Council Regulations, and a Council resolution asserting the political commitment to implement the new pact in a strict and timely manner. Resolution of the European Council on the Stability and Growth Pact [1997] OJ C 236/1; Reg 1466/97; Reg 1467/97.

812 Sanctions include additional debt reporting requirements, denial of credit from the EIB, and fines: Art 126(11) TFEU.

813 This literature is examined in Chapter 7. See generally: Rodden (2006) chapters 3, 4 and specifically 163-179. See, on Canada: Section 7.2.4. See, on Switzerland: Section 7.2.4. See, on the US: Section 7.2.3. For comparative analyses of these federations, see: Bishop, Damrau and Miller (1989); Lamfalussy (1989).


815 *Gauweiler II (Opinion of AG Cruz-Villalón)* (131) [191]. See also: *Pringle v Ireland* [135].

1951 the Treaty of Paris established the European Coal and Steel Community (ECSC) in order to liberalise trade and ‘remove the main obstacle to an economic partnership,’ \(^{817}\) and integration under a common market and customs union was shortly pursued by the Treaty of Rome in 1957. \(^{818}\)

Legal scholarship searching for the historical origins of contemporary EMU frequently begin with the ECSC or the EEC. Padoa-Schioppa, for example, suggests that monetary union was ‘implicit’ at the founding of the EEC, \(^{819}\) and the Commission has, since 1962, repeated the refrain that economic integration ‘would be incomplete, and therefore possibly ineffective, if not comparable action were undertaken in the field of monetary policy.’ \(^{820}\)

Yet until 1985, the refrain that monetary union is necessary for a single market had no basis in law or economics. \(^{821}\) Article 235 EEC provided a competence to propose any action necessary for the functioning of the Common Market, \(^{822}\) but arguments that a single currency was somehow necessary for an internal market were generally viewed by EEC central bankers as disingenuous. \(^{823}\) This was made clear in 1958, when the EEC Central Bank Governors agreed that the Monetary Committee established under Article 105 EEC could not be a forum for monetary cooperation; that the governors could not be bound by decisions of the EEC; and that monetary cooperation should not take place within the EEC legal order. \(^{824}\) Until 1986, proposals for a monetary ‘Europe of the Six’, or the creation of a regional reserve system, also repeatedly failed to make it out of the EEC’s own Monetary Committee. \(^{825}\) Monetary Policy remained completely outside the European legal order.


\(^{819}\) Gillingham, _European Integration_ (2003), 271.

\(^{820}\) Commission of the EEC, Memorandum on the action programme of the Community for the second stage (Memorandum) COM(62) 300, paras 127-128, 130; Commission of the EC, 'Contributions by the Commission' (1990), 19; European Commission, 'The road to EMU' (European Commission, Economic and Financial Affairs, 17 July 2015) <http://ec.europa.eu/economy_finance/euro/emu/road/index_en.htm> accessed 22 August 2016 (‘the potential of the internal market could not be fully exploited as long as relatively high transaction costs linked to currency conversion and uncertainties linked to exchange rate fluctuations, however small, persisted’).

\(^{821}\) The Treaty of Rome did not give the EEC any competence in monetary policy. The EEC Treaty contained provisions extolling each Member State to ensure a stable currency (Article 103 EEC); it provided for an advisory ‘Monetary Committee’ to promote coordination in ECOFIN (Article 105 EEC); it forbade exchange-rate policies liable to distort the internal market (Article 107 EEC); and it authorised mutual assistance in the event of BOP difficulties (Article 108 EEC) - but monetary policy remained completely outside the European legal order.

\(^{822}\) Art 235 EC Treaty stated: ‘If action by the Community should prove necessary to attain, in the course of the operation of the common market, one of the objectives of the Community and this Treaty has not provided the necessary powers, the Council shall, acting unanimously on a proposal from the Commission and after consulting the Assembly [European Parliament], take the appropriate measures.’

\(^{823}\) James (2014), 42: ‘the argument that a single currency was ‘necessary’ for a market was always something of a stretch.’

\(^{824}\) James (2014), 44-45.

The reason for this is a principle of monetary economics known as the ‘Mundell-Fleming trilemma’ or the ‘impossible trinity.’

826 There is no doubt that fluctuating exchange rates divide national economies and distort the optimal location of economic factors. However, it must not be missed that what is required for a single market is not a single currency. What is required is currency convertibility. Currency convertibility in turn requires exchange-rate stability, and exchange-rate stability in heterogeneous economies requires independent monetary policies.

**Figure 3 A Single Market Requires Exchange-Rate Stability**

Fluctuating exchange rates distort cross-border pricing. Fixed exchange rates create cross-border price stability.

This is the ‘impossible trinity’: Maintaining exchange-rate parity is only tenable where central banks are capable of affecting the value of currency. In any monetary union, there are two main mechanisms setting the basic price of credit: ‘the price of borrowing from the central bank by eligible deposit-taking institutions’ (the interest-rate channel) and ‘the quantity of base money.’

828 Therefore, in order to (1) maintain a fixed exchange-rate, the central bank must be able to (2) affect the quantity of base money through the adjustment of interest rates, and (3) the ability to control the money supply through capital controls. It is impossible to have fixed exchange rates without independent

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828 Willem H Buiter, Ebrahim Rahbari and Juergen Michels, 'The implications of intra-area imbalances in credit flows' (2011) CEPS Policy Insight. Base money is the sum of central bank overnight credit to banks and currency already in circulation. The interest rate channel is the effect of the interest rate on the cost of capital: An increase in money supply accelerates purchasing and investment decisions. The credit channel is the amplification effect of the interest rate on the cost of credit - an increase money supply to banks increases the supply of loans to the economy.

829 The monetary base, or base money, consists of the total quantitate of currency which comprises commercial bank reserves (including the accounts with the central bank, the total currency circulating in the public, and currency physically held in the bank’s vault). The money supply consists of the total quantity of currency circulating in the public, plus personal deposits.
interest rates and capital controls. As will become relevant in Chapter 3 of this thesis, in the absence of capital controls, an increase in the rate of interest intended to absorb money in the system will have the opposite effect: as capital moves in order seek greater returns, capital inflows and may actually increase the national money supply. By the reverse token, if capital outflows can be restricted at a time when markets expect a devaluation, capital controls and the interest rate are an effective method of managing the value of the currency. In short, a loss of monetary sovereignty would be fundamentally incompatible with the exchange-rate fixity required for the single market.

For this reason, until 1992, monetary cooperation took place entirely outside the European legal order. Until 1971, Bretton Woods required each country to maintain fixed parities (±1%) using the dollar pegged to gold at $35 per ounce, and the European currency ‘Snake’ (1972-1979) and European Monetary System (EMS) (1979-1992) required European central banks to maintain the value of their currencies within a ±2.25% band. Each of

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831 By the reverse token, a central bank which intends to increase the monetary supply by reducing interest rates may trigger an outflow of capital as it seeks a higher rate of return. Jovanović (2002) 116-117; Barre Report I, 5.

832 Raising the interest rate restricts credit, while capital controls force investors to hold low-yield domestic currency who might otherwise wish to sell it, so the amount of currency in circulation is controlled. Miodrag Jovanović, ‘Sovereignty - out, constitutional identity - In’ (2015) 56 Acta Juridica Hungarica 1588, 115; Jovanović (2015), 116.


835 The band was assessed on a Parity Grid of bilateral rates evaluated in European Currency Units (ECU’s). The Italian Lira, Spanish Peseta, Portuguese Escudo and British Pound Sterling were permitted to fluctuate within a band of ±6%. Committee of Governors, Strengthening the Operating Mechanisms of the EMS (Basel-Nyborg Agreement) (8
these fulfilled the legal requisites of an internal market, and none occurred within the EEC legal order.  

Throughout these decades, the Commission continued to push its thesis that the single market required full monetary union. In 1962, the Commission argued that monetary union was necessary for the ‘cohesion of the Common Market’. In 1969 the Barre Report proposed integrating monetary support into the EC legal order. In 1970, the Werner Report proposed a complete monetary union with centralised control over national budgets and extensive fiscal transfers. In 1971, the Commission endorsed the Werner Report and submitted its own proposals for EMU. When that failed in 1973, proposals to transform the whole complex of monetary cooperation into the EEC under a new currency and a ‘Eurofed’ were promulgated in 1975, 1976, and 1977. None of these proposals led to monetary union. Monetary cooperation took place between some EEC states and not others, or outside the EEC entirely. In 1964, side-meetings at the BIS between EEC Central bankers were institutionalised as the ‘Committee of Governors of the Central Banks of the

See: European Council Resolution of 5 December 1978 on the establishment of the European Monetary System (EMS) and related matters, in Compendium of Community Monetary Texts (Monetary Committee, 1986) 43; Agreement of 13 March 1979 between the central banks of the Member States of the European Economic Community laying down the operating procedures for the EMS, in Compendium of Community Monetary Texts (Monetary Committee, 1986) 47.


Commission, Memorandum on the action programme for the second stage COM(62) 300, paras 127-130.


See: James (2014), 140.

EEC’ (the ‘Committee of Governors,’ or ‘CoG’), but this remained an ‘appendage’ of the Bretton Woods monetary system, ‘not an EEC institution.’ In 1978 the EMS was promulgated by a Council Resolution, but in legal terms it was governed by another ‘soft law’ agreement between central banks, outside the EC legal order. At no point had any of the intergovernmental monetary arrangements constituted a ‘monetary embodiment of the EEC.’ The Werner Report was never fully implemented, and was rejected by the CoG in 1973. Later proposals to bring EMS monetary cooperation into the EEC as the embryo of a ‘Eurofed’, were roundly criticized as ‘whistling in the dark’. In 1974 the Bank of England asserted that ‘The Euro-bond market is not an EEC phenomenon and therefore no useful purpose would be served by attempting any kind of monitoring in an EEC framework.’ In 1976 the CoG Chairman asserted that the Snake was ‘not an instrument of community integration.’ In 1977, the Bundesbank and De Nederlandsche Bank refused to institutionalise monetary supports under the EEC framework, stating that to do so would create a cycle of financing lasting deficits and exceed the ECI legal order. In 1988 Bundesbank President Karl Otto Pöhl warned, presciently:

‘In a monetary union with irreversibly fixed exchange rates the weak would become ever weaker and the strong ever stronger. We would thus experience great tensions in the real economy of Europe.’

Such was the state of affairs until 1985, when Commission President Jacques Delors launched the ‘1992’ program with the humble aim of completing the internal market, resulting in the Single

845 The Committee of Governors never concerned itself with the sustainability of the exchange-rate. James (2014), 53, 56-58. It was a response to calls for monetary coordination following a speculative attack on Italy in March 1964 that reduced its reserves by $82m in just two days. See generally: Tsoukalis (1977), 54; Dyson and Featherstone (1999), 20-24; Chang (2009); James (2014), 20-22, 45-50, 52-53, 260, 266-270, 281-298
846 It was a ‘non-act’ adopted by a ‘non-body’: David AO Edward and Robert C Lane, Edward and Lane on European Union Law (Edward Elgar 2013), 845. See: Agreement of 13 March 1979 on the EMS.
848 Two expert groups were formed under the umbrella of the Monetary Committee on 3 March 1971, but they accomplished little in coordinating economic policies. Similarly, warnings from the Council in 1972 and 1973 were non-binding and ineffectual: James (2014), 85. See further: Gillingham, European Integration (2003), 87. The Delors Committee took the Werner Report for its starting point (Committee for the Study of EMU, Economic and Monetary Union: The Main Issues (1 September 1988, CSEMU/2/88)), but the Delors model was fundamentally different from the centralized Werner model. See: Nölling (1993), 45.
850 As recorded in: James (2014), 121.
851 As recorded in: James (2014), 140.
852 In 1972 Germany further argued that an EMCF with a legal personality was not in compliance with the Treaty. See: James (2014), 124.
European Act (SEA) in 1986.\textsuperscript{854} On its face, the SEA ‘was not very ambitious’ and seemed to require little in the way of transfers of sovereignty.\textsuperscript{855} The 1992 programme contained a ‘hidden agenda’, however.\textsuperscript{856} This was so because at the heart of the SEA was complete capital liberalisation.\textsuperscript{857} According to ECB historian Harold James, Delors was keenly aware that the 1992 program would trigger the ‘impossible trinity’, depriving Member States of the ability run independent monetary policies.\textsuperscript{858} One month after the SEA was signed, Delors commissioned the \textit{Padoa-Schioppa Report}, which spelled out the consequences of capital liberalisation - the impossible trinity had been set in effect:

‘In a quite fundamental way, capital mobility and exchange rate fixity together leave no room for independent monetary policies. In these conditions, it is pertinent to consider afresh the case for a strengthened organisation of monetary coordination or institutional advances in this field … There are serious risks of aggravated regional imbalance in the course of market liberalisation.’\textsuperscript{859}

ECB historian Harold James speaks of the European central bankers being ‘brilliantly inveigled’ into monetary union.\textsuperscript{860} Perhaps appropriately, the EMS collapsed in 1992, the year for which the 1985 programme was named.

Following the \textit{Padoa-Schioppa Report}, the European Council commissioned a report on EMU by the ‘Delors Committee,’ comprised of the twelve EEC central bank governors under the leadership of Jacques Delors, and it is here where the \textit{travaux préparatoires} leading to Maastricht begin.\textsuperscript{861} The 1989 \textit{Delors Report} is often credited as the blueprint for EMU,\textsuperscript{862} however it should be noted that its task was not to make concrete proposals (indeed, the \textit{Bundesbank} and the Bank of England considered that EMU was not desirable and refused to deliver a political statement in its favour).\textsuperscript{863}

\textsuperscript{854} The simple objective was to create ‘an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured.’ Commission of the EC, 'Completing the Internal Market' (White Paper) COM(85) 310 final; Single European Act [1987] OJ L 169/1.

\textsuperscript{855} Alina Kaczorowska, European Union (2nd edn, Routledge 2011), 16.

\textsuperscript{856} Kaczorowska (2011), 19.

\textsuperscript{857} Art 26(2) TFEU, ex Art 14(2) EC.

\textsuperscript{858} Article 20 SEA contained an apparently idle reference to EMU which Delors fondly recalled as his ‘little white pebble’ leading to monetary union. James (2014), 231-232. See also: Kaczorowska (2011), 16.


\textsuperscript{861} European Council, 'European Council Hanover Summit of 27-28 June' (1988) Bull EC 6/1988.Three independent experts also sat on the Committee: These were Alexandre Lamfalussy, the General Manager of the BIS, Danish economist Niels Thygesen, and former Spanish Finance Minister Miguel Boyer. The remaining four participants consisted of men affiliated with the European Commission: Frans Andriessen, Commission President Jacques Delors, Tommaso Padoa-Schioppa, and Jean-Paul Mingasson.


\textsuperscript{863} See: Jacques Delors, Letter to Dr. GD Baer, Bank for International Settlements (1 September 1988). Prior to the preparatory committees, neither the \textit{Delors Report} nor the Community bodies had ‘yet discussed to what extent irrevocable exchange rates or even a single currency will make it necessary to transfer powers and decision-making to the
Instead, the political thrust of the Delors report was approved by the European Council in June 1989, and the real task of designing the EMU was charged to four competent bodies tasked with carrying out the preparatory work for the Maastricht IGC: The Commission, the Committee of Governors, ECOFIN and the Monetary Committee alternates. The remainder of this Chapter relies heavily on the travaux préparatoires of these committees.

2.2 The Principles of Economic & Monetary Union

The fundamental guiding principles of EMU are set out in Article 119 TFEU (ex Article 4 EC). That article provides for the establishment of the European Economic and Monetary Union. It states:

‘(1) [T]he activities of the Member States and the Union shall include, as provided in the Treaties, the adoption of an economic policy which is based on the close coordination of Member States' economic policies…

(2) Concurrently with the foregoing … these activities shall include a single currency, the euro, and the definition and conduct of a single monetary policy and exchange-rate policy the

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866 The Commission submitted three main inputs for the Maastricht IGC: (1) Commission of the EC, One market, one money (European Economy No 44, 1990), a technical document which was initially intended as the input for the work of the Delors committee; (2) Commission, ’Economic and Monetary Union‘ SEC (90) 1659 which set out the official Commission view of the EMU system; (3) and a draft Treaty that formed the de facto starting point for first part of the conference: Commission of the EC, ’Contributions by the Commission‘ (1990) See: Ludlow (1991), 397.

867 The Committee of Governors was responsible for drafting the statutes ESCB and ECB. See: James (2014), 20-22, 52-53, 260, 266-270, 281-298; Dyson and Featherstone (1999), 58.

868 The Monetary Committee was the main chamber for technical negotiations on economic governance. Its contributions are widely acknowledged as the real ‘blueprints’ of EMU. Monetary Committee of the EC, ’Result of the discussion in the Committee on 24 April‘ (Meeting Minutes) [1990] II/185/90-EN; Monetary Committee, EMU Beyond Stage I (1990).

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primary objective of both of which shall be to maintain price stability and, without prejudice to this objective, to support the general economic policies in the Union...

(3) These activities of the Member States and the Union shall entail compliance with the following guiding principles: stable prices, sound public finances and monetary conditions and a sustainable balance of payments.'

The guiding principles of stable prices, sound public finances and a sustainable balance of payments are foundational constitutional values of the Economic and Monetary Union.\(^{869}\) It is the achievement of these principles for which the entire architecture of Articles 120-126 TFEU, 127(1) TFEU, and Articles 2-3 and 17 to 24 of the Statute of the ESCB, is constructed, and it is against these principles which those substantive provisions are interpreted.\(^{870}\) A final principle, the principle of fiscal sovereignty, is not written in Article 119 TFEU nor any substantive provisions in the Treaties. It written only in what is outside the EU legal order. Under the allocation of competences for economic policy under Articles 2(3), 5(1), and 120-126 TFEU, the EU has no competence in economic policy.\(^{871}\) According to the travaux préparatoires, these principles impress themselves on each piece of the legal architecture of EMU.

2.2.1 Price Stability

Price stability binds both monetary policy and the construction of European fiscal federalism. As the European Council so puts it, ‘the entire design of the monetary and economic rules in the treaty is guided by the overriding Treaty objective to create a stable single currency.'\(^{872}\) Price stability is the ‘sine qua non for economic and monetary union’ - the principle for

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\(^{869}\) Commission of the EC (1990), 17; Commission, 'Towards a Stability Pact’ II/011/96-EN, 10 January 1996, 9; and Committee of Central Bank Governors of the EEC, Introductory Report to the Draft Statute of ESCB (19 September, 1990), 3, referring to these principles as principles ‘of a constitutional nature.’

\(^{870}\) Pringle v Ireland [48], [51], [55], [77], [92], [135]. Commission of the EC, 'Contributions by the Commission' (1990), 35: The purpose of these provisions is to enforce ‘the minimum rules with which Member States will have to comply in the budgetary sphere in order to prevent the appearance of imbalances which might compromise monetary stability.’ See also: European Council Conclusions of 15-16 December 1995, 24.

\(^{871}\) Pringle v Ireland [64]; Gauweiler I (Germany) [39]; De Nederlansche Bank (2004), 27; Fabbrini (2013), 35.

which the entire chapter on economic policy (Articles 120-126 TFEU) and the entire chapter on monetary policy (Articles 127-133 TFEU) of Title VIII TFEU is drafted.\textsuperscript{873}

The instatement of price stability over other historical objectives for monetary policy, such as full employment or growth, has both constitutional and economic parentage in the \textit{travaux préparatoires}. As a matter of law, as shown in Chapter 1, price stability derives from the constitutional imperatives of the German Basic Law.\textsuperscript{874} Herdegen explains:

‘In its famous decision on the Treaty of Maastricht, the German Constitutional Court has qualified EMU as a "community of stability" which could forfeit Germany's adherence if it wandered astray: should EMU not live up to the high standards of stability, then Germany, according to the Constitutional Court, could pull the plug and leave the Monetary Union altogether. […] The Maastricht Treaty makes price stability the very essence, the \textit{raison d'être} of EMU, a preeminence unparalleled in legal history.’\textsuperscript{875}

As a matter of economics, monetary price stability was chosen as necessary for the achievement of the objectives of the single market: balanced economic growth and the efficient allocation of resources.\textsuperscript{876} While a range of economic policies, such as full employment or economic growth are also dependent on the supply and value of the currency, the European Parliamentary report to the Maastricht IGC remarked a pan-institutional consensus that price stability had proved, by a process of natural selection over the 1970-1980’s, to be ‘more effective’ than competing policies at fostering cross-border investment, growth and employment.\textsuperscript{877} Price stability was therefore the uncontested starting point at


\textsuperscript{874} See Section 1.3.2. In particular, Art 88 BL. \textit{Brunner (Germany)}: ‘This modification of the democratic principle for the purpose of protecting the confidence placed in the redemption value of a currency is acceptable because it takes account of the special characteristic (tested and proven - in scientific terms as well - in the German legal system) that an independent central bank is a better guarantee of the value of currency, and thus of a generally sound economic basis for the state's budgetary policies and for private planning and transactions in the exercise of rights and economic freedom.’

\textit{Herdegen (1998), 12-16}

\textsuperscript{875} Art 3(3) TFEU. High inflation distorts efficient pricing at microeconomic level by disrupting consumer perceptions of cost differences disrupting labour markets and wage bargaining. See: Malcolm Crawford, \textit{One Money for Europe? The Economics and Politics of EMU} (Macmillan Press 1993) 182; Tommaso Padoa-Schioppa, \textit{The Road to Monetary Union in Europe} (Clarendon Press 1994), 172: ‘Europe has been vaccinated by the painful experiences of high inflation in the 1970s and disinflation in the 1980s. Even in countries with large budget deficits, central banks have found widespread support for a strong commitment to price stability.’

\textsuperscript{876} \textit{Herman Report Part B} (1990), 23-23. On this consensus, see: Maurice O’Connell, 'Irish Attitude to EMU and the Irish Conditions for Entry' (Conrad Hotel, Dublin, 21 March 1991), noting that although Ireland had proposed full employment as an objective for monetary policy, Ireland accepted that ‘in the longer term a stable economic environment with low inflation will be an essential precondition for steady growth and more employment.’ See also: Committee of Governors, \textit{Report of 26 March 1990} (1990) (26 March 1990) 3; Padoa-Schioppa, \textit{The Road to Monetary Union} (1994); Herdegen (1998); James (2014); ECB, \textit{Monetary Policy and Inflation Differentials in a Heterogenous Currency Area} (ECB Monthly Bulletin May 2005), 74. Cf. Crawford (1993), 182 (arguing that price stability should be ‘discounted’ as a benefit of EMU).
Maastricht.\textsuperscript{878} The CoG and Monetary Committee submissions at Maastricht were clear: ‘the first priority and objective in the Community should be price stability.’\textsuperscript{879}

2.2.2 Fiscal Discipline

As a matter of public economics, sound public finances and a sustainable balance of payments are condition precedent to price stability in a federated monetary union.\textsuperscript{880} As Bishop explains, in purely economic terms there are two principal requirements for a federated monetary union to be credible and permanent:

Budgetary discipline - in order maintain solvency and to prevent spillovers on monetary policy; and

A sustainable balance of payments – so that the single monetary policy does not cause inflation in one country and deflation in another, causing weaker countries to become impoverished.\textsuperscript{881}

Put simply, if price stability is the \textit{sine qua non} of EMU, fiscal discipline (economic policy) is the \textit{sine qua non} of (monetary policy) price stability. This is particularly so in the EMU, where there is no substantial federal counter-cyclical policy and no mechanism of financial assistance for members experiencing a balance of payments (BoP) crisis.

According to Optimum Currency Area (OCA) theory, a currency union must have certain mechanisms in place if it is to remain stable and permanent.\textsuperscript{882} One of these is a fiscal stabilisation capacity to stabilise asymmetric shocks and ensure the solvency of the state during BoP imbalances.\textsuperscript{883} This is so because vital macroeconomic tools which allow a state to remain solvent during public-sector and BoP deficits – the interest rate, capital controls, and the tax base – are

\textsuperscript{878} Rory O’Donnell and Patrick Honohan (eds), \textit{Economic and Monetary Union} (Institute of European Affairs 1991), 19 (‘it was broadly accepted before the Maastricht negotiations that ‘if there is to be a European monetary union it will be based on a treaty which incorporates these principles [price stability and central bank independence]... this is so, if only because Germany will not agree to monetary union on any other terms.’); Sandholtz (1994), 126 (‘The most basic issues - central bank independence, the mandate for price stability - simply were not contested’).


\textsuperscript{880} Commission of the EC, ‘Proposal for a Council Regulation (EC) on the strengthening of the surveillance and coordination of budgetary positions’ (Proposal) COM(96) 496 final, 1.


\textsuperscript{883} The others are: high factor mobility, real price and wage flexibility, and a large fiscal stabilisation capacity.
unavailable in a monetary union with full capital liberalisation.\textsuperscript{884} The result is that the burden of adjustment must fall on economic and fiscal policy if the state is to remain solvent.\textsuperscript{885}

Proponents of a European fiscal union have regularly seized on this prescription to argue for the centralisation of fiscal policy in the Union.\textsuperscript{886} In reality, however, this is not necessarily entailed by OCA theory.\textsuperscript{887} What is required by OCA theory is that an adequate fiscal buffer be maintained to safeguard solvency and stabilise the economy in periods of adjustment, regardless of whether this is at federal or at state level.\textsuperscript{888} What is absolutely necessary, therefore, is fiscal discipline.\textsuperscript{889}

If fiscal discipline is not maintained, there are a number of spillover mechanisms which jeopardise price stability. The first is monetary financing: the central bank may be pressured to ‘bail out’ insolvent governments, either by buying government debt and lowering risk premiums or simply by diluting the value of the currency.\textsuperscript{890} The second is default-risk spillovers: as countries running large fiscal deficits will have increased recourse to the capital markets of the Union, higher borrowing costs may spread to the treasuries, companies and electorates of other countries exposed to the defaulting state.\textsuperscript{891} The third is currency-risk spillovers: the more the debt-servicing burden grows,


\textsuperscript{887} Mundell's OCA theory emphasized factor mobility, but did not call for a centralized fiscal capacity. It was only later that Kenan (1969) argued that a large 'federal' spending capacity could help a great deal in offsetting symmetric shocks. Neither argued it was required. See: Marek Dabrowski, 'Fiscal or Bailout Union: Where is the EU/EMU's Fiscal Integration Heading?' (2013) 2014/1 Revue de l'OFCE No 132; Dabrowski, 'Fiscal and Macroeconomic Governance' (2015), 8.


\textsuperscript{889} Commission, 'Ensuring Budgetary Discipline in Stage Three of EMU’ II/409/96-EN, 19 July 1996, 6; ‘A sound budgetary discipline is paramount in order to allow the necessary flexibility to cope with adverse economic circumstances without shifting the public finances onto an unsustainable course.’

\textsuperscript{890} Feust and Peichl (2012), 3 explain: ‘This is because financial difficulties of one member country may threaten the stability of financial markets, create pressures to monetise public debt and interfere with monetary policy.’ For an analysis of how the central bank can be pressured, see: A Lans Bovenberg, Jeroen JM Kremers and Paul R Maason, 'Economic and Monetary Union in Europe and Constraints on National Budgetary Policies' (1991) 38 IMF Staff Papers 374, 380; Giovannini and Spaventa (1995), 249-252.

\textsuperscript{891} Wyplosz, 'Dark sides' (2006), 225; Thomas Laubach, 'New Evidence on the Interest Rate Effects of Budget Deficits and Debt' (2009) 7 JEEA 858 (long-term treasury yields rise approximately 25bps per pp in the projected deficit-to-GDP ratio, and 3-4bps per pp increase in the debt-to-GDP ratio). The dilemma is compounded by a demonstrable free-riding
the more currency markets will it as a possible source of currency depreciation, increasing the cost of EMU-denominated debt.  

Under all three channels, the mechanism is the same: The upward pressure on interest rates saps the fiscal stabilisation capacities of the Member States and has a ‘crowding out’ effect on investment, increasing pressure on the central bank to engineer a monetary expansion.  

If the central bank refuses, the result may be to trigger a deep recession. Once such problems arise, economic policy choices may become bounded and self-perpetuating, swinging pendulously between recession or the default/withdrawal of a Member State, on one hand, and excessive deficits and monetary financing, on the other. "Bundesbank" President Weidmann explains:

‘Excessive government debt therefore represents a massive threat to price stability. Putting an effective limit on government borrowing is thus a primary pillar of any policy of stable money.

Monetary union, as a union of stability, therefore required sound public finances."  

Near identical conclusions were expressed by the Delors Report, the Commission’s One market one Money report, the Monetary Committee report of April 1990, and the CoG Report of 26 March 1990:

‘Sound budgetary policies are indispensable and complementary to stability-oriented monetary policies."  

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894 This was seen in Germany in the wake of the second oil shock in 1979-1981 (Moravcsik (1999), 257) and during the currency crisis of 1992: Gillingham, European Integration (2003), 290-292.

895 Commission, One market, one money (1990), 168: ‘If this impact [of regional economic disparities] is negative, collective welfare considerations in the EMU could lead it to the decision to reduce it by enhancing the role of central public finance. If the latter does not take place, regional disparities might become such that countries may have an incentive to withdraw from EMU’.


897 Weidmann (2013).


899 Commission, One market, one money (1990), 168: ‘excessive deficits that lead to exploding public debts are not compatible with EMU.’ See, also, Commission of the EC, 'Contributions by the Commission' (1990), 24, ‘Excessive budget deficits may endanger the stability-oriented monetary policy. As a matter of principle, excessive budget deficits therefore must be avoided and this should be stated in the Treaty.’

900 Monetary Committee, Results of the Meeting of 24 April 1990.

2.2.3 Fiscal Sovereignty

Not only must the model chosen to ensure price stability ‘work’, but it must remain within the containment walls of Europe’s constitutional boundaries. 902 As shown in Chapter 1, fiscal sovereignty is a constitutional precondition that constrains the European legal order as a whole. 903 So, for example, the CoG rejected proposals for a hard legal constraint on budgetary powers, 904 and the Monetary Committee insisted that ‘the authorities in the Member States must remain masters of the main aspects of budgetary policy’. 905 Centralised fiscal governance, legally-binding fiscal rules, and centralised finance mechanisms were ruled out of court - ‘politically unacceptable just as much [as] legally inadmissible.’ 906 According to the Monetary Committee, the EU could have no power to influence the composition of revenue and expenditure. 907

The Delors Report introduced the concept of subsidiarity in order to protect national economic imperatives. 908 Yet the budgetary competences of the Member States were not ultimately entrusted to a principle of the internal ordering of competence by EU institutions. 909 As stated by the Conseil Constitutionnelle, subsidiarity ‘does not, of itself, prevent those transfers of powers authorized by the Treaty … having such a broad ambit and taking effect in such a manner as to affect the essential conditions for the exercise of national sovereignty.’ 910 Instead, the drafting committees and

902 Decentralisation of fiscal policy functions was considered axiomatic from the earliest stages of work preparatory work for the Maastricht Treaty See, e.g., Committee of Governors, Minutes of the 245th Meeting of the Committee of Governors of the Central Banks of the EEC (1990), 36; Monetary Committee, EMU Beyond Stage I (1990); Ludlow (1991); Moravcsik (1999); James (2014). See also: Dieter Biehl, ‘Reform of the EC Financial Constitution’ in Harry Cowie (ed), Towards Fiscal Federalism: Federal Trust Conference Report (Federal Trust for Education and Research 1992) 19.
903 See Chapter 1, Section 1.3.1.
905 Monetary Committee, EMU Beyond Stage I (1990) paras 2, 9, 15.
906 Hugo J Hahn, ‘The Stability Pact for European Monetary Union: Compliance with Deficit Limit as a Constant Legal Duty’ (1998) 35 CMLR 77, 85. See further: Ludlow (1991) 398: ‘Even the most communautaire of governments did not favour a return to the prescriptions or practices of the 1970’s’ where, even after economic coordination as rejected, ‘the Council had introduced elaborate machinery for economic policy coordination.’ See also: Bini Smaghi, Padoa-Schioppa and Papadia (1994), 28, (a centralised finance mechanism, ‘would not be politically acceptable’); and Karl Otto Pöhl, ‘The further development of the European Monetary System’ in, Collection of papers submitted to the Committee for the Study of EMU (1989) 64: ‘The very ambitious nature of the Community’s ultimate objectives - to achieve an economic union and to found a political entity - has been used as a reason for refusing to go too fast in relinquishing sovereignty.’
907 Monetary Committee, EMU Beyond Stage I (1990), paras 2, 5: any Community mechanism for the coordination of economic policy would have to take the form of ‘voluntary cooperation, consensus and peer-pressure’, and remain ‘confined to the overall budget balance.’ See further: Bishop, Damrau and Miller (1989), 7: ‘The fear of losing national sovereignty is widespread and exacerbated by proposals for binding budgetary rules. Such rules... are not necessary for attaining monetary union.’
908 As the Delors Report explained, the concept pre-dates EMU as an important administrative principle for any democratic regime, enshrined in the European Charter of Local Self-Government (Council of Europe, 15.X.1985). Biehl (1992): ‘subsidiarity is a reflection of the equity, the justice principle which is embodied in the extended distribution function. This would mean that preference for the smaller or lower level of government should be given even if things could be better executed at a Community level.’
909 As subsidiarity only applies within the European legal order (Art 5(1) TEU) subsidiarity ‘did not bite’ on the initial choice of what powers should be conferred on the Union: Craig, ‘Constitutional Responsibility’ (2015).
910 Re Amsterdam (France) [4], [23]. Indeed, Valery Giscard d’Estaing noted that the principle ‘should not restrain’ the ‘dynamic and constantly-evolving’ character of the Community, which was ‘continually and necessarily acquiring new powers’. See also: Gareth Davies, 'Subsidiarity: The Wrong Idea, in the Wrong Place, at the Wrong Time’ (2006) 43 CMLR 1; Marija Bartl, 'The Way We Do Europe: Subsidiarity and the Substantive Democratic Deficit' (2015) 21 ELJ 23.
European Council explicitly referred to the principle of competence – ‘that the community can only act where given the power to do so’ - for the protection of fiscal sovereignty.  

Under Articles 2(3), 5(1), 121 and 126 TFEU, the Union has no competence in economic policy. Articles 2(3) and 5(1) TFEU (coordination of economic policies) are listed separately from Articles 2(1) and 3 TFEU (exclusive competences), and 2(2) and 4 TFEU (shared competences). Instead of a conferral of competences on the EU, it is for the ‘Member States [to] coordinate their economic and employment policies within arrangements as determined by this Treaty, which the Union shall have competence to provide.’ The Union’s competence is confined to establishing ‘arrangements’ for Member States to coordinate their own economic policies. The Member States may coordinate, sanction, or cajole each other for their economic policies, but economic policy remains completely outside the European legal order.

2.2.4 Principles of Fiscal Federalism: Hard Budget Constraints and Market Discipline

In the European Monetary Union, the principle of price stability is constitutional in nature, embedded under primary EU law in the imperative form. The antecedent principles of budgetary discipline and internal balance, however, depend on continuous acquiescence and participation by the elected governments of Member States. With no centralised power of legal compulsion in economic policy, whether governments choose to act prudently will depend on the balance of incentives which play on elected decision-makers in a federated monetary union. The achievement of price stability, a creature of monetary economics, is therefore predicated on the field of public economics known as fiscal federalism.

Fiscal federalism is concerned with the structuring of financial relationships and incentives between governmental units in a federal system. That literature is applied to the EMU in-depth in Chapter 7, however it suffices to state here that the legal construction of a given federal model under fiscal

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911 European Council, Conclusions of the Presidency of the European Council in Edinburgh, 11-12 December 1992 EUCO 25/1/10 Rev 1, 14. See, e.g.: Monetary Committee, Results of the Meeting of 24 April 1990, 6, ‘subsidarity implies that the total transfer will extend no further than is necessary.’

912 Palmstorfer (2012). There is also no provision for the approximation or harmonisation of Member States’ laws, as often accompanies areas of Member States competence. Nor did the failed ‘EU Constitution’ substantially alter this dynamic, leaving it as a ‘specific’ competence. Dominique Servais and Rodolphe Ruggeri, The EU Constitution: its Impact on Economic and Monetary Union and Economic Governance in Legal Aspects of the European System of Central Banks (ECB 2005), 50; Lastra (2006), 249.

913 As Pipkorn (1994), 272, emphasises, it is in the first instance, ‘up to the Member States to conduct an economic policy that complies with the principles at the basis of the Economic and Monetary Union.’

914 Dabrowski, ‘Fiscal and Macroeconomic Governance’ (2015), 27: ‘Thus, the question of how much fiscal and political integration is needed must be answered … by the theory of fiscal federalism rather than OCA theory.’ See also: Wyplosz, ‘Centralization-Decentralization’ (2015), ‘The Make-up of the EU institutions, and their evolution, should explicitly be based on accepted federalism principles.’

federalism theory depends on its placement on a continuum between (fully centralised) fiscal union and (decentralised) fiscal sovereignty.\footnote{916 Teresa Ter-Minassian and Jon Craig, 'Control of Subnational Government Borrowing' in Teresa Ter-Minassian (ed), \textit{Fiscal Federalism in Theory and Practice} (IMF 1997) 157. In the context of the EU, Hinarejos refers to these as the ‘classical’ model and the ‘surveillance’ model. Hinarejos, 'Limits to Fiscal Integration' (2014); Hinarejos, \textit{Constitutional Perspective} (2015). See also: Eyraud and Gomez Sireya (2014); Isabelle Joumard and Per Mathis Kongsrud, 'Fiscal Relations across Government Levels' (2003) OECD Economics Department Working Papers No 375; IMF, \textit{Macro Policy Lessons for a Sound Design of Fiscal Decentralization} (IMF, 2009), 40; Raji Singh and Alexander Plekhanov, 'How Should Subnational Government Borrowing Be Regulated?' (2005) IMF Working Paper No 5, 6. For other versions of the federalism 'spectrum' see: William S Livingston, \textit{Federalism and Constitutional Change} (Clarendon Press 1956); William H Riker, \textit{Federalism: Origin, Operation, Significance} (1964).} occupant one end of the spectrum lie highly decentralised federations such as the United States,\footnote{917 See Chapter 7, Section 7.2.3.} Switzerland,\footnote{918 See Chapter 7, Section 7.2.2.} and Canada.\footnote{919} In these countries, debt is not mutualised, finances are not controlled by the centre, and there is no federal oversight of state-level expenditure, revenue or debt. For the Delors Committee, the main technical input to the preparatory work examining these federations was a paper submitted in 1989 by BIS Director Alexandre Lamfalussy.\footnote{920 Lamfalussy (1989) 102.} The Lamfalussy paper noted that, with no mechanisms of economic coordination, and ‘no \textit{federally imposed} constraints on regional government borrowing,’ none of these federations have ‘experienced serious problems with, or been much concerned about’ fiscal imbalances.\footnote{921} In these federations, fiscal discipline is enforced by market discipline. As defined in a seminal IMF staff paper by Lane in 1992, ‘Market discipline means that financial markets provide signals that lead borrowers to behave in a manner consistent with their solvency.’\footnote{922 See Chapter 7, Section 7.2.4.} As investors know that each State/Canton/Province is ‘on its own’ in relation to its liabilities, markets closely monitor sub-federal finances and price default risk into government debt. A government which borrows against a fixed envelope of resources will face rising credit risk premiums as they approach their inter-temporal budget constraint.\footnote{923 Lane (1993), 55 (emphasis in original).} Eventually, it becomes ‘cheaper to make expenditure cuts and/or raise money through taxes at home than to continue to borrow, and they change their behaviour’,\footnote{924 Lane (1993), 54. In order to remain within its inter-temporal budget constraint, a government must ensure that the present value of all its revenues is at least as large as its existing debt, plus expenditures.} Ultimately, a country which is unable to refinance its commitments will be cut off from the markets.\footnote{925 Mark Hallerberg, 'Fiscal federalism reforms in the European Union and the Greek crisis' (2010) 12 Eur Union Polit 127, 130.} This model has a centuries-old empirical pedigree, and is known to the fiscal federalism literature as the ‘ideal type’ or ‘classical’ model of federalism (sometimes known as ‘market-preserving federalism,’ ‘self-preserving federalism,’ or ‘competitive federalism’).\footnote{926 See Chapter 7. Barry R Weingast, 'The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Development' (1995) 10 JL Econ & Org 1; Yinyi Qian and Barry R Weingast, 'Federalism as a Commitment
‘Despite the fact that scholars of comparative federalism are conducting research in remarkably diverse national contexts, they are increasingly united in their prescription for the economic complications of some federations.’

Occupying the other end of the spectrum lie highly centralised fiscal unions (such as Australia or Germany). These states exhibit what is referred to in the European context the ‘centralisation’ or ‘surveillance’ model, characterised by comprehensive fiscal transfers and centralised oversight of sub-federal budgetary policies. In these federations, the central government exerts ‘such a degree of fiscal control that credit distinctions between the constituent states are almost non-existent.’ So, for example, all sixteen Germany Länder enjoy credit ratings in the highest rating category, despite wildly different base risk, and despite the fact that Bremen and the Saarland are so in excesses of the solvency condition that their default would become immediately necessary without constant infusions of financial assistance.

According to the 1989 Lamfalussy paper, three characteristics determined whether fiscal discipline was found in a fiscal federation: Complete spending and revenue autonomy, no bailouts, and ‘no federally imposed constraints on regional government borrowing.’ Indeed, Lamfalussy found that where fiscal discipline did break down, such failure was invariably caused by some attempt ‘to enforce restraint on state governments.’ The paper concluded:

‘A key aspect of all the federal systems considered is the denial (or strict limitations) of access to central bank financing to regional governments in an attempt to subject them to the discipline of the market.

Federally-decided limits on the borrowing of regional governments exist only in Australia...[and] except for Australia... no country appears to have experiences serious problems with, or been much concerned about, medium-term control over sub-federal budgetary positions. [...] This centralization has meant that financial markets have not been encouraged to differentiate between the debts of the various government units, in sharp contrast to the Canadian Case. Some concern would also seem to exist in Germany, where tax powers are highly centralized.


927 Wibbels (2003), 476.
928 Hinarejos, 'Limits to Fiscal Integration' (2014); Hinarejos, Constitutional Perspective (2015).
930 See: Chapter 7, Section 7.2.1.
and there are a number of institutional, albeit mainly consultative, arrangements for coordination.\footnote{Lamfalussy (1989) 98, 102-106.}

The lesson left to the drafting committees was clear. The Monetary Committee report to the IGC stated: ‘it must be clear that the Member States do not stand behind each other’s debts... Measures should be taken to reinforce market discipline over budget deficits.’\footnote{Monetary Committee, EMU Beyond Stage I (1990) [4] (ii).}

For the architects of EMU at Maastricht, this ‘market-preserving’ model of fiscal decentralisation was not merely a choice, but a constitutional requirement.\footnote{See, e.g., The first memorandum of the Delors Committee: Committee for the Study of EMU, Main Issues (1988), 4 for example, concluded that, ‘In nations with a federal structure, in which there is one currency and once central bank, no formal constraint is in general imposed by the federal authorities on the budgetary decisions of local governments. It is clear from experiences of highly centralised administrations that, in the interests of both democracy and efficiency, the principle of decentralization should be espoused. See also: Commission of the EC, ‘Contributions by the Commission’ (1990), 22 (‘There does not need to be a single economic policy in the same way as for monetary policy... Even in mature federations economic policy is made up of different functions and is conducted at different levels of government... this has not only a theoretical but also a solid empirical foundation... Most economic policy functions will remain the preserve of Member States even in the final stage of economic and monetary union.’ See further: Maurice Doyle, ‘Regional policy and European economic integration’ in, Collection of papers submitted to the Committee for the Study of Economic and Monetary Union (Delors Committee) (1989) 69, 78.}

As stated by the Commission, ‘In the end achieving stable public finances will depend on the successful self-discipline of Member States... There are sensitive issues concerning parliamentary sovereignty over budgetary policy, and in any case no single model would be appropriate given the diversity of historical and constitutional backgrounds.’\footnote{Commission, ‘Towards a Stability Pact’ II/011/96-EN, 10 January 1996, 14.}

Similarly, the Padoa-Schioppa Report concluded:

‘[T]he decentralised model evident in the mature federations, where the capital market exerts some restraint on state borrowing, is more plausible in the long-run than power-sharing arrangements that have sometimes been considered.’\footnote{Padoa-Schioppa Report (1987), 9.}

There are three requirements for market discipline to be effective according to fiscal federalism theory, and it is these requirements upon which the Maastricht Treaty architecture is based.\footnote{See: Monetary Committee, EMU Beyond Stage I (1990) [4] (ii); Committee of Governors, Minutes of the 245th Meeting of the Committee of Governors of the Central Banks of the Member States of the EEC (1990); European Council, ‘Meeting of 27-28 October 1990 (Rome)’ (1990), 11; Bini Smaghi, Padoa-Schioppa and Papadia (1994), 5. Commission, ‘Economic and Monetary Union’ SEC (90) 1659 , 24. See also: Bishop, Damrau and Miller (1989), 1; Lane (1993), 62.}
The first condition for the application of market discipline is a credible ‘no bailout’ rule, accompanied by ‘a strict prohibition on monetary and compulsory financing of public deficits or privileged market access for public authorities.’ The preparatory committees were unanimous on this point. The CoG Report of March 1990 and the Commission’s report to the IGC recorded ‘the consensus on two rules, namely no monetary financing of budget deficits and no bailout out or unconditional Community guarantee.’ Similarly, the European Council concluded that advancement to EMU would only occur after ‘the monetary financing of budget deficits has been prohibited and any responsibility on the part of the Community or its Member States for one Member State’s debt precluded.’ The July 1990 Monetary Committee Report stated:

‘Each Member State must bear the responsibility for its own debt management and must ensure that it is in a position to honour its engagements. The Member States will follow budgetary policies which respect the principles of budgetary discipline:

[I] Monetary and compulsory financing of public deficits should be excluded. This implies that government should have no access to central bank financing and that financial institutions should not be obliged to acquire government paper for the purpose of financing the public sector deficit. […]

[II] It must be clear that neither the Community nor the other Member States stand behind a Member State’s debts. The ‘no bail-out’ rule would ensure that the financial markets exercise a degree of discipline on any Member State pursuing unsound budgetary policies, by imposing differential terms on its paper and ultimately by refusing to lend.

Second, full information on the borrowers’ existing liabilities and creditworthiness must be readily available to market participants, creditors and government stakeholders in order for costs and pressure on governments to arise. An obvious remedy to ensure adequate information is to ‘improve the quality of information and disseminate it to the markets’ through some sort of

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939 This is necessary in order to ‘enable financial markets to be exerted on excessive borrowing by a Member State.’ will be shown in Chapter 7, where sub-federal treasuries can expect a bailout from the federal government, a central bank, or even ‘captured’ financial institutions, they do not face a ‘fixed envelope’ of resources and borrowing costs do not rise in response to the balance of liabilities and own resources. Monetary Committee, EMU Beyond Stage I (1990) [4]; Committee of Governors, Report of 26 March 1990 (1990), 2.

940 Committee of Governors, Minutes of the 245th Meeting of the Committee of Governors of the Central Banks of the EEC (1990). See also: Commission, ‘Economic and Monetary Union’ SEC (90) 1659, 24: ‘two rules should feature in the treaty: (a) no monetary financing of public deficits or market privileges for the public authorities concerning the placing of public debt; (b) no bailout-out rule.’


942 Monetary Committee, EMU Beyond Stage I (1990), 2.

943 See Chapter 3, Section 3.3.2. Bishop, Damrau and Miller (1989), 1: Full data on the ‘maturity structure of all of the debt servicing obligations likely to be faced by a government are essential if the markets are to form a proper judgment of the risks.’ Markets will fail to apply risk premiums where imbalances accrue hidden to creditors: European Commission, ‘Surveillance of Intra-Euro-Area Competitiveness and Imbalances’ (2010) European Economy No 1; Thomas Mayer, ‘Euroland's hidden balance-of-payments crisis’ (2011) Deutsche Bank Research EU Monitor No 88, 2; James T Bennett, Thomas J DiLorenzo, Underground Government: The Off-Budget Public Sector (Cato Institute 1983); Lane (1993), 62.
multilateral surveillance framework. To this end, the preparatory committees recommended a second mechanism: ‘appropriate procedures to monitor budgetary policies and identify slippages which may occur.’

The third and final condition for effective market discipline is correction: Governments must not be inure to market sanctions – they must actually undertake fiscal policy adjustment. In the travaux préparatoires to the Maastricht Treaty, this condition is expressed as ‘the avoidance of excessive deficits.’ In a constitutional democracy, this condition is typically ensured by electorates and creditors. As the cost of debt becomes increasingly unsustainable and spending priorities are curtailed, political stakeholders are forced to resolve internal ‘wars of attrition’ over the costs of adjustment.

However, a government which is rewarded for rising debts, either because the costs are shared with the wider federation or because the failure is perceived to be the fault of outsiders, will be less likely to respond. For this reason, the preparatory committees recommended ‘a second direction of policies’ to support market discipline. The Commission explained that a multilateral sanctioning mechanism ‘could be expected to impact on public opinion in the country concerned. It would certainly influence market perceptions leading to a downgrading in the credit rating of the Member State in question.’

Figure 9 Principles of EMU: The Legal Architecture of European Fiscal Federalism

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944 Lane (1993). Bishop, Damrau and Miller (1989), 19 note that, ordinarily, ‘a wide range of information is available to the analyst interested in arriving at a credit judgment regarding a sovereign borrower... Finance ministries and central banks publish timely and reliable data on the finances of sovereign borrowers. International entities, such as the [OECD], the [IMF] and the [EC] itself; regularly monitor the economies of European sovereigns.


950 Commission, 'Towards a Stability Pact' II/011/96-EN, 10 January 1996, 9-10; Commission of the EC, 'Contributions by the Commission' (1990), 31 Member States who pursue unsustainable policies, will ‘have to justify their attitudes not only vis-a-vis the Community institutions but also vis-a-vis domestic public opinion.’
2.3 The Legal Architecture of European Fiscal Federalism

The legal architecture of European fiscal federalism consists of three pillars:

[2.3.1] The prohibition on financial assistance under Articles 123-125 TFEU;

[2.3.2.1] The Multilateral Surveillance Procedure under Article 121 TFEU; and

[2.3.2.2] The Excessive Deficit Procedure under Article 126 TFEU.

2.3.1 The Prohibition on Financial Assistance

Central to European fiscal federalism since Maastricht has been the ‘no bailout’ rule (Article 125 TFEU, ex 103 EC) and the prohibition on monetary financing (Article 123 TFEU, ex 101 EC) which enshrine a constitutional consensus on fiscal sovereignty and expose individual Member States to market discipline. Neither can be read independently of their preceding articles.951 The ‘no bailout’ rule is but the ‘final piece’ of an integrative structure which functions to cut off access to all non-market public finance under Articles 122-125 TFEU.952 Member States are cut off from access to privileged financing from the ECB (Article 123); from ‘captured’ private financial institutions (Article 124); and from each other (Article 125). The only exception to this structure is Article 122(2) TFEU, which restricts financial assistance to natural disasters or exceptional occurrences beyond the control of the Member State. There is nothing in the way of a financial umbrella to protect EMU Member States against insolvency. As Louis explains:

‘The market is supposed to sanction the profligacy of Member States by increasing risk premiums on bonds. ... The no-bailout clause is an essential part of the “budgetary code” of the Union. Member States are “on their own” as far as their public finances are concerned. They have to finance themselves, if necessary, on the market and at the conditions set by the market. Markets are the judges of their financial health.’953

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951 Louis (2010), 977.
That these four provisions comprise a single interlocking framework for that purpose is referenced explicitly in various treaty and secondary law provisions, and is described clearly throughout the travaux préparatoires of the Monetary Committee, the CoG, and the Commission, the latter of which states:

‘The Treaty contains a number of elements that reinforce the role of market pressure in favour of fiscal discipline… There are four main provisions in the Treaty stating in concrete terms the aforementioned principle:

[1] Article 104-104a [now 123-124 TFEU]: prohibition of monetary financing and privileged access to financial institutions.

[2] Article 104b [now 125 TFEU]: no bail-out rule… This rule is designed to dispel any investor’s doubt, or hope, about the risk they run in financing governments that incur excessive deficits.”

[3] Article 104c [now 126 TFEU]: excessive deficit procedure… The procedure may lead to publication of Council recommendations addressed to a specific Member State. … That would result in an increasing market pressure on this country (market asks a higher price on its debt) to adopt corrective measures in favour of fiscal discipline.’

2.3.1.1 Article 125 TFEU: The No Bailout Rule

The ‘no bailout’ rule contains two identical sentences, one addressed to the Union and one addressed to the Member States. They state:

‘[The Union/A Member State] shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project.’

Article 125 is the constitutional touchstone of the two canons of the European fiscal federalism in this thesis. First, the ‘no bailout’ rule entrenches fiscal sovereignty. As Louis so puts it, it is, beyond

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954 Article 125(2) TFEU explicitly ties these provisions together, referring to ‘the prohibitions referred to in Articles 123, 124 and [125]’. Similarly, Council Regulation (EC) no 3603/93 of 13 December 1993 specifying definitions for the prohibitions referred to in Articles 104 and 104b(1) of the Treaty [1993] OJ L 332/1 describes Article 124 TFEU as ‘an essential element of the submission of the public sector in its financing operations to the discipline of the market mechanism [that] so makes a contribution to the strengthening of budgetary discipline.’

955 Monetary Committee, EMU Beyond Stage I (1990), 2, recited in full, infra, Chapter 2, Section 2.3.1.1, p 128.


958 Art 125(1) TFEU [emphasis added]. As Art 13(2) TEU requires the institutions listed in Art 13(1) TEU to remain within the limits of, and conformity with, the powers, procedures, conditions and objectives set out therein, the prohibition under Art 125(1) will apply to all the institutions of the Union.
its literal wording, ‘the expression of the responsibility of each Member State for its own public finance.’ Bishop explains:

‘The purpose of the [no bailout] rule is clear: it is the circuit breaker between monetary union and the back-door creation of a ‘United States of Europe’. When you look at the creation of monetary unions and federations in the past... you see all too often that when one of the members of the club got into financial difficulties, the other members of the club had an interest in helping that member and in doing so, they take control over their spending. Finally and inexorably there was a centralisation of political power.’

The second is hard budget constraints and individual liability to market discipline for the purposes of price stability and fiscal discipline. In Pringle v Ireland, the ECJ described this teleology as follows:

‘It is apparent from the preparatory work relating to the Treaty of Maastricht that the aim of art.125 is to ensure that the Member States follow a sound budgetary policy. [1] The prohibition laid down in art.125 TFEU [2] ensures that the Member States remain subject to the logic of the market when they enter into debt, since [3] that ought to prompt them to maintain budgetary discipline. Compliance with such discipline contributes at Union level to the attainment of [4] a higher objective, namely maintaining the financial stability of the monetary union.’

2.3.1.2 Article 123 TFEU: The No Monetary Financing Rule

The monetary counterpart to Article 125 TFEU, the ‘no monetary financing’ rule, prohibits the ESCB from financing Member States directly, through primary bond purchases (which are prohibited outright), or indirectly, through secondary market instruments which have the effect of monetary financing. According to the travaux préparatoires, this serves three purposes: to ring-

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959 Louis (2010), 978. See also: Merino (2012), 1626 ‘the Member States are responsible for their own budgets’; Borger (2013), 118, underpinning the Treat model lie only two disciplinary forces: ‘self-restraint and market discipline’; and Zeitler (2014), 246.


961 Pringle v Ireland [135]; Gauweiler II (Opinion of AG Cruz-Villalón) [191].

962 Pringle v Ireland [135]. Numbers and emphasis added.

963 Primary market bond purchases are purchases of government bonds directly from the issuer.

964 A secondary market bond purchase is the purchase of a government bond from a third party other than the issuer.
fence price stability against expansionary fiscal policy; to safeguard the independence of the ECB; and to ensure that Member States are exposed to market discipline. Article 123 TFEU is read together with Regulation 3603/93 specifying definitions for the application of Article 101 EC. That regulation states that ‘purchases on the secondary market must not be used to circumvent the objective of Article 123’ and defines ‘other type of credit facility’ as ‘any financing of the public sector’s obligations vis-à-vis third parties’ and ‘any transaction with the public sector resulting or likely to result in a claim against that sector.’ Article 123 TFEU states:

‘Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments.’

According to the BVerfGE, AG Villalón, and the ECJ, Article 123 TFEU is to be interpreted purposively: It prohibits any operations on the secondary market ‘whose effect is to circumvent the above-mentioned prohibition’ by having the effect of financial assistance. According to the ECJ, ‘Article 123(1) TFEU prohibits all financial assistance from the ESCB to a Member State.’ It is, in short, a ‘no bailout’ rule tailored to the ECB.

2.3.1.3 Article 124 TFEU: No Privileged Access to Public Finance

Article 124 fills the gap between these two rules by preventing governments from capturing, colluding or inducing financial institutions to lend to them at below-market rates. Article 124 TFEU reads:

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965 Committee of Governors, Monetary Financing of Budget Deficits in Stage Three (19 June, 1991) 2-4. See also: Jean-Claude Trichet, 'The ECB’s response to the recent tensions in financial markets' (38th =Conference of the Oesterreichische Nationalbank, Vienna, 31 May 2010); Athanassiou (2011), 567. See also: ECB, Monthly Bulletin October 2012 (ECB 2012), 8; Article 123 TFEU means that ECB instruments must ‘not interfere with the three objectives of the monetary financing prohibition: (i) the primary objective of price stability, (ii) central bank independence, and (iii) fiscal discipline.’

966 Preamble, Reg 3603/03.

967 See also: Art 21.1 of the Statute of the ESCB.

968 Gauweiler I (Germany) at [86];

969 Gauweiler II (Opinion of AG Cruz-Villalon) [227].

970 Gauweiler II (CJEU) [94]-[95].


972 Gauweiler II (CJEU) [94]-[95].


974 For the preparatory work, see: Monetary Committee, Meeting of 24 April 1990, 2; and Committee of Governors, Report of 26 March 1990 (1990), 2-3: ‘The exclusion of the direct financing of budgetary deficits by the central banks does not avoid undesired monetary consequences of budgetary laxness; governments can cover public deficits in the banking system and this may produce the same adverse monetary effects as direct monetary financing.’ In Gauweiler v Bundesbank, a major concern was that financial institutions would purchase government debt and immediately turn around and sell them to the ECB:Gauweiler I (Germany) [87], [92]; Gauweiler II (CJEU) [104]-[108]; Gauweiler III (Germany) [10].
‘Any measure, not based on prudential considerations, establishing privileged access by Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States to financial institutions, shall be prohibited.’

This is an adjunct to the ‘no bailout’ rule which stops governments from raiding private financial institutions. As stated by the Monetary Committee: ‘financial institutions should not be obliged to acquire government paper for the financing of the public sector deficit.’

2.3.1.4 Article 122 TFEU: (No) Conditional Financial Assistance

Perhaps the truest cornerstone of this architecture, however, is present by its absence: Nothing vaguely related to conditional financial assistance in the event of a threat to economic or monetary stability appears in the Treaty, except those provisions which expressly preclude such a mechanism. Instead, Article 108 EEC - which has afforded the protection of ‘mutual financial assistance’ since the Community’s founding Treaty – was removed from the title on EMU at Maastricht.

This was a clear drafting choice. After being roundly rejected by the technical committees in 1989-1990, the Commission attempted to reintroduce the question of conditional financial assistance by inserting two articles into the draft treaty which formed the de-facto starting-point for the Maastricht IGC. Articles 104 and 104a of the Commission draft treaty provided a legal basis for a financial stability mechanism remarkably prescient of the European Stability Mechanism (ESM) enacted two decades later in 2012. Article 104a presaged the ‘narrow’ interpretation of the ‘no bailout’ rule later to be adopted in Pringle v Ireland (see Section 6.4) by narrowing its scope to a prohibition on ‘unconditional guarantees in respect of the public debt of a Member State.’ Article 104 then watered-down the substance of the ‘no bailout’ principle itself into a ‘conditional bailouts’ principle, remarkably prescient of that which would be established as Article 136(3) TFEU in 2012 (see Section 6.1.4). It read:

‘Where a Member State is in difficulties or is seriously threatened with difficulties […] subject to certain conditions, the Member State concerned [may] be granted Community financial

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975 Monetary Committee, EMU Beyond Stage I (1990), 2.
976 Art 143 TFEU (ex 108 EC) allows for ‘mutual financial assistance’ to be granted to a non-EU Member State if measures recommended by the Commission are insufficient to counter economic difficulties which have arisen.
977 Monetary Committee, EMU Beyond Stage I (1990), 2; Committee of Governors, Report of 26 March 1990 (1990), 2. See also: Padoa-Schioppa, The Road to Monetary Union (1994) 174, it was seen as ‘essential that traps of this sort be avoided in the design of the European Monetary Union.’
979 See: Chapter 6, Section 6.4.
980 Art 104 EC of the Commission draft Treaty: Commission of the EC, 'Contributions by the Commission' (1990), 42 read: ‘The following shall be recognised as incompatible with the economic and monetary union and shall accordingly be prohibited: … (b) the granting by the Community or the Member States of an unconditional guarantee in respect of the public debt of a Member State.’ Cf. The interpretation of the ECJ Pringle v Ireland, examined in-depth below, Section 6.4.
assistance which may take the form of a support programme accompanied by budgetary intervention or special loans. 981

Conditional financial assistance had already been rejected by the technical committees in 1989-1990, 982 it was excluded from the mandates for the IGC by the European Council in Rome, 983 and it was rejected (derisively) by ECOFIN in 1990. 984 Instead, ‘mutual financial assistance’ under the existing Article 108 EEC was stripped from the title on EMU, and, to ensure such a mechanism never arose again, ‘the Monetary Committee [wrote] itself out of the future of the European design.’ 985

As will become important later in this thesis, the reason for this, according to travaux préparatoires of the Delors Committee, 986 the CoG, 987 and the Monetary Committee, 988 was that Europe’s historical experience of non-credible commitments and integrationist institutions meant that the Union simply could not be trusted to enforce its own criteria for fiscal discipline in a debt crisis. 989 According to the deliberations of ECOFIN, ‘the whole history of European integration’ was one of political interference in attempts to impose conditionality on member countries. 990 In the Monetary Committee, it was predicted that ‘Country conditionality would be watered down by politics, including by interventions by the Commission.’ 991 According to Padoa-Schioppa on the Monetary Committee and CoG, it was seen as ‘essential that traps of this sort be avoided in the design of the European Monetary Union.’ 992 If any financial assistance was to be got, it would have to be obtained

981 Art 104 EC of the Commission draft Treaty: Commission of the EC, 'Contributions by the Commission' (1990), 42. See the interpretation of the ECJ Pringle v Ireland, examined in-depth in Chapter 6, Section 6.4.
982 Monetary Committee, EMU Beyond Stage I (1990), 2; Committee of Governors, Report of 26 March 1990 (1990), 2.
983 Where the October 1990 summit lists agreement for the preparatory work, conditional financial assistance is not among them: ‘[There is agreement] that the overriding objective of monetary policy should be price stability ... that excessive budget deficits should be avoided, and that there should be no monetary financing of deficits nor the assumption of responsibility on the part of the Community or its Member States for one Member State’s debt.’ European Council, 'Meeting of 27-28 October 1990 (Rome)), 9 and European Council in Rome, 14-15 December 1990 [1990] EC Bull 12.
984 European Council, Maastricht European Council of 9-10 December 1991 [1991] Bull EC No 12. See also: Ludlow (1991) the Commission’s proposal was seen as ‘remarkably short on serious economic analysis... rough treatment at the hands of ECOFIN was predictable and was presumably anticipated.’
987 Committee of Governors, Minutes of the 245th Meeting of the Committee of Governors of the Central Banks of the Member States of the EEC (1990), 10.
988 Monetary Committee, EMU Beyond Stage I (1990), 4.
989 Bishop, Damrau and Miller (1989) 14: ‘European “pork barrel” politics [affords] little confidence that late-night, budget cooperation deals would not fall into the same trap... The EC’s binding budgetary rules could well be as vulnerable.’
990 See the deliberations of the Monetary Committee and ECOFIN, as recorded in James (2014), 279-280.
991 See the deliberations of the Monetary Committee and ECOFIN, as recorded in James (2014), 279-280.
992 Padoa-Schioppa, Road to Monetary Union (1994) 174. Padoa-Schioppa sat on the Monetary Committee and the CoG.
through the IMF.\textsuperscript{993} Any country which had not achieved sufficient convergence should simply be left out of the process.\textsuperscript{994}

All that was left in the way of a financial assistance umbrella in the Treaties is Article 122(2) TFEU:

‘Where a Member State is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control, the Council, on a proposal from the Commission, may grant, under certain conditions, Union financial assistance to the Member State concerned.’\textsuperscript{995}

Two features of this article are of note. First, the occurrence justifying financial assistance ‘has to be exceptional and not manageable under any other Treaty provisions’ - a limitation that does not apply under 143 TFEU (ex 108 EEC) to Member States outside the EMU.\textsuperscript{996} It requires: (i) severe difficulties, (ii) caused by exceptional circumstances, which (iii) are beyond the control of the Member State. It is ‘a true crisis clause’, which narrowness only serves to emphasise the ‘limited scope for exercising financial solidarity.’\textsuperscript{997}

Second, Article 122(2) TFEU is different from Article 143 TFEU (ex 109 EEC), which is a standalone competence – an unfettered legal basis - to give financial assistance to Member States outside EMU where its internal criteria are met. As there is no ‘no bailout’ rule applying outside EMU, Article 143 TFEU is not subject to any external restrictions on its activation. Article 122(2) TFEU, by contrast, was drafted explicitly as a lex specialis, ‘a kind of escape clause’, to the no-bailout rule.\textsuperscript{998} This is made explicit by Declaration No. 6 on Article 100 EC, which refers to ‘decisions regarding financial assistance, such as are provided for in Article [122 TFEU] and are compatible with the ‘no bail-out’ rule laid down in Article [125 TFEU].’\textsuperscript{999} It is also made explicit by Article 122(1) TFEU, which states that Article 122 TFEU is ‘without prejudice to any other procedures provided for in the Treaties’ (including Article 125).

\subsection{2.3.2 The Stability and Growth Pact (SGP)}

There were no centralised fiscal rules in the design of EMU at the time of the signing of the Maastricht Treaty in 1992. Until 1997 the only penalty was non-admission for those outside it, and

\textsuperscript{993} ‘The IMF was the better vehicle for conditionality.’ Jean-Claude Trichet, as recorded in: James (2014), 280.

\textsuperscript{994} A majority of the Monetary Committee further recommended a legal mechanism for active enforcement of the prohibition on intra-EU financing. Monetary Committee, EMU Beyond Stage I (1990); Monetary Committee, Meeting of 24 April 1990. See also, the account in: Bini Smaghi, Padoa-Schioppa and Papadia (1994), 13.

\textsuperscript{995} For the interpretation of Art 122(2), see: Pringle v Ireland [132]; Merino (2012), 1633; Louis (2010), 983; Borger (2013), 119 and Athanassiou (2011), 561.

\textsuperscript{996} See: Louis (2010), 981.

\textsuperscript{997} Louis (2010), 983 (‘true crisis clause’); Lastra (2006), 253 (the removal of Art 143 TFEU from the EMU can only serve to emphasise the ‘limited scope for exercising financial solidarity’).

\textsuperscript{998} See: Louis (2010), 981, noting z ‘consensus among legal scholars that art.122(2) establishes an exception to the no-bailout clause.’ It was a compromise between countries which objected to the removal of emergency assistance under Article 108 EEC, and those which it would ‘be open to misuse for unjustified transfers.’ Pipkorn (1994), 273.

\textsuperscript{999} Declaration No 6 (emphasis added).
the cold winds of the markets for those within it.\textsuperscript{1000} Proposals for a mechanism to ensure budgetary discipline in stage three (competed EMU) were not introduced until 1995, and the SGP did not enter into effect until January 1999, nearly a decade after Maastricht.\textsuperscript{1001} When proposals for a stability pact were considered a half-decade later, there was no agreement even on ‘how a stability pact could be implemented within existing Treaty arrangements under Article 103 and 104c’, or whether ‘alternative arrangements’ would be needed.\textsuperscript{1002} As observed by the UK Treasury Department in November 1989:

‘Fixed exchange rate regimes have in the past operated successfully without such rules, as do the overwhelming majority of federal states today. Market pressures and multilateral surveillance will prevent deficits becoming unsustainable or unneighbourly. Binding Community rules are undesirable because, being unnecessary, they infringe the principle of subsidiarity... [and are] quite likely to have undesirable effects including the introduction of a degree of moral hazard.’\textsuperscript{1003}

Articles 121 and 126 TFEU were drafted not as fiscal rules but as a ‘no entry’ clause.\textsuperscript{1004} The Treaty signed at Maastricht struck a compromise in the decades-long ‘economist’ and ‘monetarist’ dispute on whether EMU would begin only once set economic entry requirements were met,\textsuperscript{1005} or whether EMU would begin at a set date, with institutional support for convergence once inside EMU.\textsuperscript{1006} The compromise signed into law at Maastricht was that the completion of EMU would begin on a set date (1 January 1999), and in return binding convergence criteria – including binding limits on

\begin{footnotesize}
\begin{enumerate}
\item[1001] Commission Proposal for a Council Regulation on speeding up and clarifying the excessive deficit procedure; Commission, ‘Towards a Stability Pact’ II/011/96-EN, 10 January 1996.
\item[1002] Commission, ‘Towards a Stability Pact’ II/011/96-EN, 10 January 1996, 8. One might regale here that the Lamfalussy paper had found that fiscal breakdowns were invariably caused by some attempt ‘to enforce restraint on state governments.’ Alexandre Lamfalussy, Memorandum to the Committee of Governors (31 January 1989) as reported in: James H, Making the European Monetary Union (Princeton University Press 2014), 249.
\item[1003] HM Treasury, An Evolutionary Approach to Economic and Monetary Union (HM Treasury, 1989) (emphasis added).
\item[1004] Giovannini and Spaventa (1995), 255.
\item[1005] The ‘Economist’ school of thought (consisting mainly of ‘strong’ currency countries with strong trade surpluses, competitive industry and low inflation) was that economic convergence was that macroeconomic convergence must come first, and monetary union could come later. Because inflationary policies would become self-perpetuating and quickly unsustainable under conditions of capital mobility, economist proposals avoided establishing rigid timetables so that the project could be aborted if the preconditions of the ‘stability bloc’ were not met. This included Germany, the Netherlands, and Italy until 1970. For the history of the ‘Economist’ position, see: Moravcsik (1999), 241-259; James (2014), 70-72; Kenneth H F Dyson and Kevin Featherstone, The Road to Maastricht (Oxford University Press 1999); Nölling (1993) 44-45; Bini Smaghi, Padoa-Schioppa and Papadia (1994), 16; Tsoukalis (1977); Sandholtz (1994); Majocchi (1999) 80-81; Jovanović (2002), 92 and James (2014), 70-77 and 101.
\item[1006] The ‘Monetarist’ formula (espoused mainly of ‘weak’ currency countries and integrationist European institutions) was that a fixed currency and common monetary institutions would be established at a set date, and common institutions would facilitate convergence thereafter. For the history of the ‘Monetarist’ position, see: Bini Smaghi, Padoa-Schioppa and Papadia (1994); Sandholtz (1994); Moravcsik (1999), 241 et seq; James (2014), 73 et seq. On the debate, see: Mazzucelli and College (1997), 67-69; Dyson and Featherstone (1999) 242-285; Moravcsik (1999) 379-472; James (2014) 210-323.
\end{enumerate}
\end{footnotesize}
government debt – would be inscribed in the Treaty.\textsuperscript{1007} The limits on government debt could not be legally binding as a matter of law, however, for that would encroach on Member State fiscal sovereignty – a constitutional boundary.\textsuperscript{1008} Instead, a procedure for avoidance of ‘excessive deficits’ was agreed.\textsuperscript{1009} This allowed countries to maintain sovereignty over their budgets, but the decision over whether an excessive deficit existed would be made by the Council acting by QMV on the basis of a Commission recommendation. For the criteria of this mechanism, the IGC settled on a debt ceiling of 60\% of GDP (which broadly approximated the community average) and a deficit ceiling of 3\% of GDP (considered consistent with the 60\% benchmark).\textsuperscript{1010} The final convergence criteria were fixed in Protocol (No 13) to the Maastricht Treaty, which stipulated that the Member States must not be ‘the subject of an “excessive deficit procedure” according to article 104c(6) [now Article 126] of the Treaty.’

The legal basis for EU surveillance and coordination therefore derives from the convergence criteria.\textsuperscript{1011} The first mention of the 3\% deficit figure arose in the context of discussions about convergence during the transition period in the Delors Committee in January 1989,\textsuperscript{1012} and attempts to define ‘excessive deficits’ in the Monetary Committee occurred in the context of ‘the decision to advance from Stage 1 to Stage 2.’\textsuperscript{1013} Where the 1990 Rome European Council Conclusions listed the settled grounds of agreement for the mandate to the IGC, centralised fiscal rules in EMU was not among them.\textsuperscript{1014} Further progress in ‘economic convergence’ was, however, and it was this clause which led to the development of debt brakes. Crawford observes:

‘In the end, there was a good deal of agreement with the UK position [that fiscal rules were not needed in an established EMU], but the risk that a country with an incipient insolvency

\textsuperscript{1009} This solution was recommended by the Italian delegation and the Commission in 1991: Bini Smaghi, Padoa-Schioppa and Papadia (1994), 27.
\textsuperscript{1010} The 3\% deficit limit was considered consistent with the 60\% debt-GDP ratio on the basis of a 5\% long-term rate of growth in nominal GDP. See: O’Donnell and Honohan (1991) 37; Bini Smaghi, Padoa-Schioppa, Papadia (1994), 28-30.
\textsuperscript{1011} The first decision on centralised economic coordination adopted on 12 March 1990 was concerned exclusively with economic convergence in Stage One: Council Decision of 6 December 1989; Council Decision 90/141/EEC.
\textsuperscript{1012} Committee for the Study of EMU, Minutes of the fifth meeting in Basle (10 January 1989) as reported in: James H, Making the European Monetary Union (Princeton University Press 2014), 251 is recorded as the first mention of the 3\% deficit figure. Pöhl stated: ‘The most important thing is that we should aim for … is that we are aiming for more convergence in economic performance. If we would recommend to the Council that all member states would … reduce their budget deficit to levels, let us say below 3\% of GDP… These are the kind of recommendations we should not forget in our Report.’ See also: Padoa-Schioppa, \textit{The Road to Monetary Union} (1994) 184, arguing that, while ‘there are no compelling arguments’ for a major shift in decision-making power from national to Community authorities generally, \textit{during the convergence period}, ‘a major fiscal correction in some European countries (including Italy) is necessary to achieve greater financial and exchange rate stability in the transition towards a monetary union. To \textit{this} end… it may be appropriate to design rules which substantially reduce governments’ discretion in the budgetary field.’
\textsuperscript{1013} Monetary Committee, EMU Beyond Stage I (1990), paras 6-8.
\textsuperscript{1014} European Council, ‘Meeting of 27-28 October 1990 (Rome)’ (1990), 9 (listing agreement on price stability, excessive deficits, no bailouts and the no monetary financing rules).
problem might enter the EMU nest was considered serious enough to warrant conditions concerning fiscal discipline, if only because [...] the risk that the Eurofed, or other EC governments, might be obliged to bail such a country out, were unpredictable.\textsuperscript{1015}

Yet as early as mid-1991, the Commission warned that process towards convergence was ‘faltering’ and ‘worrying,’ and by 1996, thirteen of fifteen countries had deficits in excess of the 3% reference level.\textsuperscript{1016} In the five years leading up to the euro, the 12 founding Member States drove up their debt by more than €600bn.\textsuperscript{1017} Fully aware that the ‘no entry’ clause would prove to be no such thing (Italy, Belgium and Greece all acceded to the Euro with debt-to-GDP ratios well above 60%)\textsuperscript{1018} the ‘strong’ currency countries on the Council began to consider the need to compel convergence even inside the EMU.\textsuperscript{1019} In 1995 Germany put forward a proposal for a ‘Stability Pact’ to ensure ‘durable’ budget discipline in Stage 3 of EMU,’ and the following year the main features of a new ‘Stability and Growth Pact’ were agreed.\textsuperscript{1020} Those procedures are set out shortly, but two points must be emphasised at the outset.

First, as stated by the \textit{Conseil Constitutionnel}, Articles 120-126 TFEU do ‘not result in the transfer of any powers over economic or fiscal policy and do not authorise any such transfers.’\textsuperscript{1021} Neither Articles 121 or 126 TFEU - the legal bases for the SGP - give the EU any competence in economic policy. The 3% and 60% debt criteria are monitored and applied under the Union’s ‘coordination’ competence under Articles 2(3) and 5(1).\textsuperscript{1022} The SGP raises the political and financial cost of electing to run a deficit over 3% of GDP, just as markets do, but excessive deficits are not simply banned as a matter of law. As Article 126(11) TFEU makes clear, an elected national budget does not

\begin{footnotes}
\footnotetext[1015]{Crawford (1993) 150.}
\footnotetext[1016]{Commission of the EC, 'Resuming progress towards convergence of economic policies and performances in the Community' (Communication) SEC(91) 1291 final, 1, 3; In 1995, the Council noted that only seven Member States would have deficits below 3% of GDP by 1999: Council Recommendation (EC) No 95/326/EC of 10 July 1995 on the broad guidelines of the economic policies of the Member States and of the Community [1995] OJ L 191/24, 26. See also: Jørgen Mortensen, ‘Economic Policy Coordination in the Economic and Monetary Union, from Maastricht via the SGP to the Fiscal Pact’ (2013) CEPS Working Document No 381, 7.}
\footnotetext[1018]{Thanos Skouras, 'The euro crisis and its lessons from a Greek perspective' (2013) 35 Society and Economy 51. The Council warned that a ‘cautious stance’ should be adopted to towards the idea that the debt criteria ‘sets ceilings and not targets.’ Council Recommendation 95/326/EC, 27. See: Interinstitutional Agreement of 6 May 1999 between the European Parliament, the Council and the Commission on budgetary discipline [1999] OJ C 172/01.}
\footnotetext[1021]{\textit{TSCG (France)} [16].}
\footnotetext[1022]{Pringle v Ireland [64]; Brunner (Germany) [64], [91]; Gauweiler I (Germany) [39] (‘In this field of economic policy, the European Union is ... essentially limited to a coordination of Member States’ economic policies. ... [T]he responsibility for economic policy lies clearly with the Member States.’) See also: Hahn (1998).}
\end{footnotes}
violates EU law because it exceeds the thresholds in the Treaty. There is no legal power of compulsion. As the Commission describes it, the SGP is a ‘voluntary commitment’ to respecting the 3% deficit limit in the Treaty.

The second point to emphasise is that the SGP emerged as a ‘second direction’ of policy to support, not replace, market discipline. Secondary EU legislation would work within the context of market discipline and facilitate political accountability in Europe’s constitutional democracies. Markets and electorates remained the sole force of compulsion. As Moris et al. explain, ‘Fiscal rules supplement the monitoring of fiscal policy by voters and by financial markets… The adoption of a fiscal rule per se is not... a sufficient condition for improving fiscal outcomes.’ This was made clear by the Commission proposal for the SGP, which described the EDP not as an independent system, but as an instrument for market discipline - a procedure ‘That would result in an increasing market pressure on this country (market asks a higher price on its debt) to adopt corrective measures.’

2.3.2.1 Article 121 TFEU: The Multilateral Surveillance Procedure

The SGP entered into force on 1 July 1999. It consists of a ‘preventative arm’ (the MSP) enacted under Article 121 TFEU, and a ‘corrective arm’ (the EDP) enacted under Article 126 TFEU. The SGP has gone through multiple iterations, pursuant to amendments in 2005 (see Section 3.3.4), and 2011 (see Section 8.1). This section is concerned with how it was enacted at Maastricht.

The MSP institutionalises the surveillance system established for convergence under a non-binding ‘soft law’ method of positive integration known as the Open Method of Coordination (OMC).

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1023 A Member State may not be subject to infringement proceedings for refusing to abide by the 3% or 60% GDP limits: Art 126(10) TFEU.
1024 Commission, 'Towards a Stability Pact' II/011/96-EN, 10 January 1996, 3. See also: Case C-27/04 Commission v Council [2004] ECR I-6649 (confirming that the SGP is a political mechanism, not capable of infringement proceedings).
1025 Tommaso Padoa-Schioppa, Proceeding by Steps (Committee of Governors, 17 November, 1988): ‘To the maximum possible extent adjustment should occur by market mechanisms. A first direction of policy, therefore, should aim at making such mechanisms more effective. … However, even improved market mechanisms will not be sufficient to bring about adjustment and therefore a second direction of policies will be necessary to supplement them.’ Cf. Pierre Lamfalussy calling for a reconsideration of ‘the idea, not shared by him, that market discipline was sufficient to bring about fiscal convergence.’ at Committee for the Study of EMU (1988), 3 as recounted in James (2014), 248.
1026 The final report to Maastricht, Commission 'Contributions by the Commission' (1990), 36 observes: ‘An important factor in the success or otherwise of the procedures adopted will be transparency, given its impact on political life in each of the Member States.’ See also: Commission of the EC, 'Contributions by the Commission' (1990), 27, 31 ‘Consequently, there is a need for these procedures to be highly transparent: sufficient publicity has in particular to be assured for the recommendations which the Community would address to Member States which deviate from jointly agreed guidelines.’
1030 On the Open Method of Coordination see: Lastra (2006), 248; Luc Tholoniad, 'The Career of the Open Method of Coordination: Lessons from a "Soft" EU Instrument' (2010) 33 West Eur Poli 93; Amtenbrink and De Haan, 'Fiscal Policy Discipline versus Flexibility' (2003); Dermot Hodson and Imelda Maher, 'The Open Method as a New Mode of
The aim of the MSP is to monitor ‘the full range of economic developments in each of the Member States’ and give warning when economic policies are going off track. Since 1993, the Treaty has provided for a coordination cycle with three stages:

First, the Council, on a recommendation from the Commission, would formulate Broad Economic Policy Guidelines (BEPGs) for the Member States and the Union (121(2) TFEU).  

Second, under Article 121(3) TFEU, Member States are required to submit annual Stability and Convergence Programmes (SCP’s) outlining their planned fiscal policies. At the centre of these programmes is the ‘medium-term objective’ (MTO), a three-year target for the budgetary balance set at ‘close to balance or in surplus’ (initially interpreted as -0.5% of GDP). The programmes are then assessed by the Council (on the basis of Commission assessments) with respect to whether the programmes provided a sufficient safety margin to avoid breaching the 3% and 60% reference values.

Third, under Article 121(4) TFEU, should the Council identify ‘actual or expected significant divergence’ from the MTO or the adjustment path towards it, the Council ‘shall’ (on a recommendation of the Commission) issue a warning to the Member State to ‘take the necessary adjustment measures.’

It should be noted that, under the Treaty, Article 121 TFEU contains no legal or financial penalty for deviation from the MTO. Indeed, it must be emphasised that compliance with the MTO is not

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1032 Until 2010, these were drafted in pursuance of the Lisbon Agenda, which set targets for R&D investment, competitiveness measures, and an employment rate of 70%; European Council, Conclusions of the Presidency in Lisbon, 23-24 March 2000. The coordination cycle consisted of the issuance of broad economic policy guidelines (now the AGS); a scoreboard of quantitative and qualitative indicators (now the AMR); the agreement of national action plans outlining fiscal targets and economic reforms; and surveillance and coordination through ‘peer review’.

1033 Arts 3(1), 4, 7(1), 8 Reg 1467/97. Stability programmes are by EMU Member States and or convergence programmes are required for non-EMU Member States. Despite the different names, The content of the programme is the same for both Euro and non-Euro Member States. These included: (a) the adjustment path towards the MTO; (b) the main assumptions about economic developments and key macroeconomic variables including public investment, GDP growth, employment and inflation; (c) a description of the measures being taken under the MTO; and (d) an analysis of potential changes in the underpinning assumptions.

1034 Art 3(2)(a), Reg 1467/97. ‘Close to balance or in surplus’, was understood to be a deficit not exceeding 0.5% of GDP, however the 2005 reform amended this to allows MTOs of up to -1.0% of GDP: Arts 1(1), 2a Council Regulation (EC) No 1055/2005 of 27 June 2005 amending Regulation No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies [2005] OJ L 174/1.

1035 Art 5(1), 9(1), Reg 1466/97. If the Council considers that the objectives and contents of a programme should be strengthened, the Council will ‘invite’ the Member State to adjust its programme: Art 5(2)-(3), 9(2)-(3), Reg 1466/97.

1036 Art 6(1), 10(1), Reg 1466/97.
inscribed anywhere in primary Treaty law, and the Union has no competence to legislate or sanction objectives for Member State economic policy.

2.3.2.2 Article 126 TFEU: The Excessive Deficit Procedure

The EDP, or the ‘corrective’ arm of the SGP entered into force alongside the MSP with the object of ‘deter[ing] excessive general government deficits and, if they occur, to further their prompt correction.’ The Treaty tasks the Commission (with monitoring) and the Council with drafting recommendations and triggering a sanctioning procedure (by QMV) with four stages, as follows:

First, under Article 126(3) TFEU, the EDP is triggered by a Commission report finding that a Member State budget exceeds the 3% or 60% of GDP reference values in Protocol No 12, unless the ratio has declined ‘substantially and continuously’ and is ‘close to the reference value’, or if the deficit is ‘exceptional and temporary.’

Second, within three months, the Council ‘shall’ take a decision on whether an excessive deficit exists and, if so, issue a recommendation to the Member State setting a deadline of four months to take effective action and correct the deficit within a year (126(5)-(6) TFEU).

Third, under Article 126(9) TFEU, if the Member State fails to take effective action, the Council shall, within one month of a recommendation by the Commission, issue a decision giving ‘notice’ of non-compliance and recommending correction within appropriate deadlines.

Finally, where a Member State fails to comply with the notice within two months, Article 126(11) TFEU provides a selection of penalties to be visited on profligate Member States, including additional information on new debt issues, restrictions on credit from the EIB, and sanctions of up to 0.5% of GDP.

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1037 Rec 1, Art 1, Reg 1467/97.
1038 Art 126(2) TFEU. If the Commission considers that an excessive deficit exists, it ‘shall’ address an opinion to the Member State concerned and notify the Council. (Arts 126(3)-(5) TFEU, 3(2) Reg 1467/97) An ‘exceptional’ economic downturn is defined as an annual fall or real GDP of <2% of GDP. ‘Substantially and continuously,’ ‘close to the reference value’ and ‘temporary’ are undefined, leaving discretion to the Council. In the case of the debt-to-GDP ratio, the EDP will not be triggered where the funds are decreasing and approaching the reference value at a sufficient pace. A severe economic downturn will be considered exceptional only where there is an annual fall of real GDP of at least 2% or a particularly abrupt downturn or severe downturn in output: Art 2(2)(3) Reg 1467/97.
1039 Arts 126(6)-(7) TFEU, 2(3)-(4) Reg 1467/97.
1040 The recommendation may be made public. Arts 126(8)-(9) TFEU; Arts 4(1)-(2) Reg 1467/97.
1041 Art 6 Reg 1467/97. This was increased to four months following the 2005 reform: Art 1(5) Reg 1056/2005. The fine consists of a fixed component of 0.2% of GDP, plus a variable component. The variable component shall amount to 1/10 of the absolute value of the difference between the balance as a % of GDP in the preceding year and either the reference value for government balance; or, if non-compliance includes the debt criterion, the balance as a % of GDP that should have been achieved in that year as set out by the notice: Art 12 Reg 1467/97 of 7 July 1997. The Council shall put the EDP into abeyance if the announced measures of a Member State comply with the recommendations, and the country will remain under enhanced monitoring until the excessive deficit is eliminated: Art 126(1) TFEU; Arts 9-10, 14 Reg 1467/97.
It should be noted that while Regulation 1467/97 words the duty to apply fines in the imperative, it remains that the decision to apply fines is taken by QMV under Article 126(13) TFEU and - as was confirmed in Commission v Council, there is no legal duty to vote to apply fines even these conditions are met.

2.4 Conclusions: The Maastricht Architecture

The ‘ideal-type’ or ‘market-preserving’ model of fiscal federalism inscribed in the Treaties since Maastricht coheres to a model that is well-established in theory and well-evidenced in history. In the European Union, however, this is not a mere reflection of the efficient allocation of public choice under the principle of subsidiarity. It is a function of the constitutional boundaries identified in Chapter 1 of this thesis. European fiscal federalism rests upon two principles: Individual fiscal sovereignty - Member States are left to their devices outside the EU legal order and responsible for their own budgetary policies; and hard budget constraints and market discipline – Articles 121-126 TFEU expose Member State fiscal policies to market discipline, internalising the costs of poor economic decisions and safeguarding the price stability at the apex of EMU.

[2.2] The first principle pursued in this thesis, national fiscal sovereignty, inhabits the allocation of competences for economic policy under Articles 2(3), 5(1), 121 and 126 TFEU. Economic coordination is listed neither as a shared competence or an exclusive competence, and there is no provision for the approximation or harmonisation of Member States’ laws, as often accompany areas of Member States competence (like direct taxation). European fiscal federalism ‘rests on the principle that Member States are responsible for their own budgets.’

[2.2] The second boundary pursued in this thesis, the substantive principles of price stability, sound public finances and a sustainable balance of payments, are shown to inhere in the fundamental guiding principles which bind the construction of EMU itself under Article 119 TFEU. It is the achievement of these principles for which the entire architecture of Chapter 1 (Economic Policy) and Chapter 2 (Monetary Policy) in Title VIII TFEU is constructed.

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1042 Art 6 states ‘the Council shall impose sanctions’ where the conditions are met; Art 11 states that whenever the Council decides to impose sanctions, ‘a non-interest-bearing deposit shall, as a rule, be required’, and states that the deposits ‘shall, as a rule’ be converted into a fine if the excessive deficit has not been corrected within two years following the deposit: Reg 1467/97 of 7 July 1997.

1043 Case C-27/04 Commission v Council.

1044 This literature is examined in Chapter 7. See generally: Rodden (2006) chapters 3, 4 and specifically 163-179.

1045 Case C-27/04 Commission v Council.

1046 Under those articles, it is for the ‘Member States [to] coordinate their economic and employment policies within arrangements as determined by this Treaty, which the Union shall have competence to provide.’ Art 2(3) TFEU.

1047 Servais and Ruggeri (2005), 50; Lastra (2006), 249. See: Palmstorfer (2012), pointing out that Arts 2(3) and 5(1) TFEU (coordination of economic policies) is listed separately from Arts 2(1) and 3 TFEU (exclusive competences) and Arts 2(2) and 4 TFEU (shared competences). See further, Hahn (1998); Pringle v Ireland [64]; Brunner (Germany) [64], [91]; and Gauweiler I (Germany) [39]: ‘In this field of economic policy, the European Union is … essentially limited to a coordination of Member States’ economic policies. … [T]he responsibility for economic policy lies clearly with the Member States.’

1048 Merino (2012) (n 1), 1626. See also: Borger (2013), 118, (underpinning the Treaty model lie only two disciplinary forces: ‘self-restraint and market discipline’).
[2.3] The Prohibition on Financial Assistance (Article 125 TFEU) in conjunction with the prohibition on monetary financing (123 TFEU) and prohibition on privileged market access (124 TFEU) enshrine a constitutional consensus on fiscal sovereignty and expose individual Member States to market discipline.\(^{1049}\) This architecture ensures that financial markets ‘exercise a degree of discipline on any Member State pursuing unsound budgetary policies, by imposing differential terms on its paper and ultimately by refusing to lend,\(^{1050}\) and is, beyond its literal wording, ‘the expression of the responsibility of each Member State for its own public finance.’\(^{1051}\) The MSP (Article 121 TFEU) and the EDP (Article 126 TFEU) ‘reinforce the role of market pressure in favour of fiscal discipline.’\(^{1052}\)

The truest cornerstone of this architecture, however, is present by its absence: A Commission proposal for conditional financial assistance was rejected by the technical committees in 1989-1990,\(^{1053}\) was rejected by ECOFIN in 1990,\(^{1054}\) and excluded from the mandates for the IGC by the European Council in Rome.\(^{1055}\) Instead, Article 108 EEC - which has afforded the protection of ‘mutual financial assistance’ since the Community’s founding Treaty – was written out of the title on EMU at Maastricht. The travaux préparatoires of the CoG,\(^{1056}\) and the Monetary Committee\(^{1057}\) and ECOFIN,\(^{1058}\) evince a consensus that Europe’s historical experience of integrationist institutions and time-inconsistent political commitments signalled that the EU could simply not be entrusted to enforce its own criteria for fiscal discipline in a debt crisis.\(^{1059}\)

\(^{1048}\) Monetary Committee, EMU Beyond Stage I (1990) [4]; Committee of Governors, Report of 26 March 1990 (1990), 2; Pringle v Ireland [135], Gauweiler II (Opinion of AG Cruz-Villalon) [191].

\(^{1050}\) Monetary Committee, EMU Beyond Stage I (1990), 2.

\(^{1053}\) Louis (2010), 978. See also: Merino (2012) 1626 (‘Member States are responsible for their own budgets.’); Borger (2013), 118 (underpinning the model lie only two disciplinary forces: ‘self-restraint and market discipline’).


\(^{1054}\) Monetary Committee, EMU Beyond Stage I (1990), 2; Committee of Governors, Report of 26 March 1990 (1990), 2; Padoa-Schioppa, The Road to Monetary Union (1994) 174, observing, that it was seen as ‘essential that traps of this sort be avoided in the design of the European Monetary Union.’

\(^{1055}\) Conditional financial assistance was not accepted at the Maastricht IGC: Ludlow (1991).

\(^{1056}\) European Council, 'Meeting of 27-28 October (Rome)' (1990), 9 and European Council, 14-15 December 1990 (Rome).

\(^{1057}\) Committee of Governors, Minutes of the 245th Meeting of the Committee of Governors of the Central Banks of the Member States of the EEC (1990), 10.

\(^{1058}\) Monetary Committee, EMU Beyond Stage I (1990), 4.

\(^{1059}\) See the deliberations of the Monetary Committee and ECOFIN, as recorded in James (2014), 279-280.

\(^{1059}\) Indeed, the Lamfalussy paper found that indiscipline was invariably caused by some attempt ‘to enforce restraint on state governments,’ signaling the vulnerability of the central government to the economic fortunes of states. Lamfalussy, ‘Macro-coordination’ (1989) 102.
This provides two testable constitutional criteria for EU fiscal federalism examined in the following chapters:

Fiscal sovereignty is a permanent constitutional constraint upon the application of fiscal federalism theory in the European Union. Any machineries of public economics which trespass on the tests for democratic legitimation in Member State legal orders will not take effect in the legal system, and will not be compatible with the European legal order, \textit{de lege lata} or \textit{de lege ferenda}.

Hard budget constraints and market discipline are indispensable requirements for price stability, sound public finances and a sustainable balance of payments under Article 119 TFEU. Systems of centralised legal governance and mutualisation of risk are not compatible with the Union’s legal order, and will fail to adhere to those principles.
3. The Failure and Abrogation of the Maastricht Model
3. The Economic Antecedents of the Euro Crisis

A legal analysis of fiscal federalism in the European Union cannot be conducted independently of its economic implications. The scope and operation of EU law is defined by substantive economic criteria: Stable prices, sound public finances and a sustainable balance of payments are fundamental principles binding on the construction of the EMU under Article 119(3) TFEU, and the constellation of provisions in Articles 121-126 TFEU are legal implements of public economics. The constitutional limits pursued in this thesis are written not only in law, but in economics.

In order to remain stable and permanent, European fiscal federalism must not only remain within its constitutional boundaries, but it must 'work.' In that regard, the EMU has now spent over half its life in a state of crisis. Some economists estimate that Europe’s GDP is now as much as 17% lower than if the euro had never been invented at all. And yet, as Europe ploughs into its tenth year of tottering imbalances, comparative federations such as the US and Canada - with no federal oversight of state budgets and no economic coordination - have long-since recovered from the global financial crisis. The United States, the originator of the 2008 financial crisis, declared its ‘Great Recession’ over in June 2009, and its largest trading partner Canada - another heterogeneous federation with comparable debt dispersion characteristics to the EU - suffered just seven months of recession.

The operational hypothesis extracted from the preceding chapters of this study is that hard budget constraints and market discipline are indispensable requirements for price stability and fiscal discipline in the European Union. In order to test that hypothesis, this chapter applies a ground-theory economic analysis of public accounts statistics and the corpus of an economic literature beginning with OCA Theory and the (in)famous ‘Walters Critique,’ and continued post-crisis by Fagan and Gaspar, Giavazzi and Spaventa, and Philip Lane (among others). The analysis seeks to


1061 EMU GDP is 17% lower than if it had continued to grow at the modest pace before the Euro was created: Joseph Stiglitz, 'The US Must Save Greece' Time (9 July 2015) <http://time.com/stiglitz-greece-crisis/> accessed 10 July 2015.


1064 The ‘Walters Critique’ refers to Sir Alan Walters’ critique of the EMS, and in particular the prediction that the EMS would prove unstable with the removal of capital controls: Walters (1990).

identify the ‘stylised facts’ of the crisis in order to provide an uncontroversial basis for legal study.\textsuperscript{1066}

The analysis finds that the \textit{causa sine qua non} of the euro crisis is a severe mispricing of private and public debt caused by a failure of Articles 121-126 TFEU to induce markets to differentiate between sovereign borrowers under a (now realised) bailout expectation. This hypothesis radically changes the incumbent prescription for European fiscal federalism. In the European Union, the crisis is commonly described as a sovereign debt crisis.\textsuperscript{1067} In particular, it is described in terms of the inability of crisis-hit periphery countries Portugal, Ireland, Italy, Greece and Spain (pejoratively acronymed the ‘PIIGS’) to run a sustainable fiscal policy.\textsuperscript{1068} All of the legal amendments examined in the second half of this thesis have been informed by the search for a legal solution to this problem.

The findings of this chapter necessarily break with that tradition. The official characterisation of the crisis is ‘given the lie’ by a simple glance at government finance statistics.\textsuperscript{1069} Of the common macroeconomic denominators which bind the periphery countries and differentiate them from the core, excessive deficits are simply not among them.\textsuperscript{1070} The ‘fatal flaw’ at the heart of the Euro is not sovereign debt; it is not caused by public-sector governance failure; and it not due to the inability of

\textsuperscript{1066}Stylised facts are empirical findings which are so consistent that they are widely understood to be empirical truths. A positive economic analysis of the law methodology refers to a system for using economic theory to explain or predict certain facts. On positive economic analysis of law, see: Faust (2008), 839–847: ‘Positive economic analysis may be employed retrospectively that is, in order to explain why the law-be it statute or case law-developed in a specific way.’ In the contest of financial markets, see: Black (2010), in particular at 159-162.


\textsuperscript{1068}Pisani-Ferry (2011) x puts it thusly: ‘Problems built up because governments did not abide by the principle of fiscal discipline…They were guilty of breaking the rules, and the current suffering of their people is fundamentally of their own making…The role of Europe is to get the incentives right by strengthening the rules and enforcement procedures.’ See, e.g., Economist, ‘PIIGS that won’t fly’ The Economist (18 May 2010) <www.economist.com> accessed 7 August 2014.

\textsuperscript{1069}Skouras (2013); Economist, The euro crisis was not a government debt crisis’ Economist (23 November 2015) 12.

\textsuperscript{1070}See: Figure 15, p 152. Fagan and Gaspar (2007), 14: ‘fiscal imbalances were remarkably similar across the two groups of countries.’ The sovereign bond spreads for which the crisis is named may not anyways, in themselves, have been sufficient to bring about a default if it weren’t for private sector interest-rate adjustment: Graham Bishop, The Future of the Stability and Growth Pact’ (2003) 6 Int Finance 297, 306 (‘if interest rates remain broadly around current levels the aggregate debt burden could rise well beyond 60 per cent of GDP without particular ill-effects for sustainability’); Lane, ‘European Sovereign Debt Crisis’ (2012), 50, 55 (‘Public debt for the aggregate euro area did not, at least at first glance, appear to be a looming problem’ - there was little concern about sovereign debt through 2008 and 2009’); Patrick Leblond, ‘The Political Stability and Growth Pact is Dead: Long Live the Economic Stability and Growth Pact’ (2006) 44 JCMS 969, 982 (interest rates were ‘not something to be alarmed at yet because debt levels remain sustainable’).
the central authority to control the public finances of its Member States. The euro crisis was a private
debt crisis, not a public one.1071

To demonstrate this hypothesis, this chapter follows the approach familiar to the literature by
dividing the original-twelve EMU countries on the basis of real interest and inflation-rates prevailing
when the decision to create EMU was taken. The ‘Periphery’ group consists of high-inflation, crisis-
hit countries Portugal, Ireland, Italy, Greece and Spain.1072 The ‘Core’ group consists of low-
inflation ‘responsible’ countries Germany, the Netherlands, Austria, Belgium, France, Finland and
Luxembourg.

The analysis is structured along a chain of macroeconomic indicators that describe a pattern of
causality running from nominal interest-rate convergence to the sovereign debt crisis. This chapter
examines: [Figure 13] short and long-term nominal interest-rates against key macroeconomic risk
indicators; [3.1.2] structural determinants of bond yields; [3.1.3] real interest rates; [3.1.4] private
sector domestic credit; [3.2.1] cross-border credit flows and consolidated banking claims; [3.2.2]
current account imbalances and external debt; [3.2.3] real effective exchange rates (REER); [3.3.1] public vs private-sector gross debt; [3.3.2] the sovereign-bank feedback loop; and [3.3.3] the (non)
effect of fiscal policy on private sector imbalances.

In order to trace this chain of causality through the failure of each pillar of the Maastricht
architecture, the analysis is divided into three parts:

Section 3.1, ‘Sovereign Bond Yields and the Failure of the Prohibition on Financial Assistance,’
finds that the introduction of the euro precipitated unprecedented nominal interest-rate convergence
which belied marked and persistent variations in underlying indicators of macroeconomic risk.1073
Markets failed to apply differentiated default risk to sovereign bonds because markets (correctly)
perceived the EMU as a joint-liability group and (correctly) guessed that the EU would sooner re-
write the treaties than allow a Member State to default.1074 Nominal convergence meant that real
interest rates in the Periphery were low or better than nil - debt was effectively subsidised by
inflation.1075 Low real interest-rates precipitated a rate of domestic credit expansion that was, on
average, 20% of GDP higher than the next eight comparable advanced-country credit cycles in

1071 For an accessible overview of the economic consensus, see: Economist, 'The euro crisis was not a government debt
crisis' (2015); Lane, 'European Sovereign Debt Crisis' (2012); Fagan and Gaspar (2008); Lane, 'Capital Flows' (2013);
1072 Some authors have excluded Greece from this group on the basis that it was not admitted to EMU until 2001. As this
Chapter is concerned with the effects of convergence, Greece is not excluded from this analysis. The PIIGS acronym is
abandoned from this point forward, as it connotes some misleading common factor of irrational excess which the analysis
simply fails to support.
1073 See: Section Figure 13.
1074 See: Section 3.1.2.
1075 See: Section 3.1.3.
history.\textsuperscript{1076} The causal denominator that binds the Periphery to the sovereign debt crisis and distinguishes them from the Core is the condition of low real interest-rates and a severe mispricing of private and public assets caused by nominal interest-rate convergence – not sovereign debt.\textsuperscript{1077}

Section 3.2, ‘Macroeconomic Imbalances and the Failure of the MSP,’ finds that nominal interest-rate convergence meant that unprecedented capital flows entered Periphery economies with no liquidity or inflation-risk premium,\textsuperscript{1078} fuelling current-account imbalances which are unprecedented in over thirty years of economic data.\textsuperscript{1079} It concludes that the failure of the Multilateral Surveillance Procedure to prevent - or even detect – historically unprecedented imbalances is attributable to well-predicted but profound information asymmetry problems known to fiscal federalism theory.\textsuperscript{1080} Put simply, in an environment of unresponsive credit prices, all of the ‘symptoms of future insolvency’ are local phenomena spread across regional banks and myriad European townships that simply cannot be supervised or governed from the centre.\textsuperscript{1081}

Section 3.3, ‘The European Sovereign Debt Crisis and the Failure of the EDP,’ finds that compliance with the Excessive Deficit Procedure does not change the pattern of causality in this chapter because sovereign debt is not a significant predictive indicator of the sovereign debt crisis - real interest-rates and private-sector credit are.\textsuperscript{1082} The spike in bond yields that make up the ‘sovereign debt crisis’ emerges in 2008 as merely the final symptom of deeply-rooted imbalances caused by the disconnection of credit from underlying economic conditions.\textsuperscript{1083} A brief counterfactual demonstrates that causality is incapable of running in reverse: Real interest rates are, in fact, ‘a monetary phenomenon’ - not a fiscal one, and no optimal fiscal policy is shown to be capable of


\textsuperscript{1077}{See: Section 3.1.5.}

\textsuperscript{1078}{See: Section 3.2.1.}

\textsuperscript{1079}{See: Section 3.2.2 and 3.2.3. By 2008-Q4, for example, the banking sectors of France and Germany alone had flooded Ireland with claims worth 130% of its GDP, and Italy, Portugal, Greece and Spain with 30% each of their GDP.}

\textsuperscript{1080}{See: Section 3.2.4.}


\textsuperscript{1082}{See: Section 3.3.1. In all five countries, the imbalances occurred entirely (Ireland and Spain), overwhelmingly (Portugal and Greece), or equally (Italy) in the private sector. It is true that 'public debt was not sufficiently reduced' in two countries (Greece and Italy), but in no country can it be said that the sovereign debt crisis would have emerged without these effects of interest rate adjustment. See: Pisani-Ferry (2011); Jean Pisani-Ferry, 'The eurozone and the streetlamp syndrome' (Bruegel, 12 December 2011) <http://bruegel.org> accessed 28 September 2016.}

\textsuperscript{1083}{See: Section 3.3.2. Jamie Caruana and Stefan Avdjiev, 'Sovereign creditworthiness and financial stability' (2012) Banque de France Financial Stability Review No 16, 71, 80; Ashoka Mody and Damiano Sandri, 'The eurozone crisis: how banks and sovereigns came to be joined at the hip' (2012) 27 Econ Policy 199, 206. See also: Carmen Reinhart and Kenneth Rogoff, 'From Financial Crash to Debt Crisis' (2011) 101 Am Econ Rev 1676, finding that the crisis sequence is as follows: (i) Credit growth, (ii) banking crises, (iii) sovereign debt crisis.
causing - or preventing - the crisis. The EDP failed to prevent the sovereign debt crisis, and anyways failed to enforce budgetary discipline on its own terms. By 2011, the SGP had been exceeded 97 times, and no sanctions for violation had ever been imposed.

By proceeding through these three analyses, this chapter finds that the ‘consensus view’ emergent from the economic literature is clear and robust: The dysfunction at the heart of the euro is the disconnection of euro area credit prices from economic fundamentals prevailing at national level – not sovereign debt. The implications of this conclusion for the duration of this study are discussed in Section 3.4, but the hypothesis it recommends is clear: The cold reality is that it is futile to centrally-govern outcomes which are, in reality, determined by myriad private individuals responding, in their economic and political lives, to dysfunctional cost incentives.

### 3.1 Sovereign Yields and the Failure of the Prohibition on Financial Assistance

#### 3.1.1 Nominal Interest Rate Convergence

Prior to the introduction of the Euro, ten-year government bonds were subject to individuated market pricing. In 1992, the year of the signing of the Maastricht Treaty, Germany borrowed at 7.84%, Italy borrowed at nearly double that rate, at 13.28%, and Greece borrowed at nearly double that rate, at 24.13% (see Figure 13). These interest rates reflected individuated market assessments of the variety of fundamentals which constitute aggregate risk in each country.

From a theoretical perspective, the price of debt may be decomposed into two components: Risk endogenous to the investment, and risk in the macroeconomic environment. Under the latter component, markets set a basic price for debt through a variety of fundamentals which indicate the economic well-being of the country. The basic price of credit on a

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1085 See: Section 3.3.4. EEAG, (2011), 94.


1088 See, e.g., Dabrowski, 'Fiscal and Macroeconomic Governance' (2015), 17.

1089 Key factors include GDP growth, inflation, government debt, national income, the balance of payments, potential output, and the international investment position. See: Moody's, Rating Methodology: Sovereign Bond Ratings (Moody's Investor's Service, 2013); Standard and Poor's, Sovereign Government Rating Methodology and Assumptions (S&P, 2013); Moody's, 'The Causes of Sovereign Defaults' (Moody's Investors Service, 1 November 2010)
riskless asset is a calculated insurance premium against risks inherent in the macroeconomic environment.

This basic price is typically represented in sovereign bond yields: All other investments in the country are exposed to the same risks as the sovereign (i.e., the credit and currency risks of the sovereign itself), but the sovereign is not typically exposed to the credit risk of individual firms. Interest premiums on government bonds can themselves be decomposed into two main components: Default risk (or credit risk) and currency risk (also known as inflation risk or exchange-rate risk). Default risk is the assessment of the probability of a sovereign default itself: The more likely it is that the creditor may not be paid back, the more they demand in the way of interest to compensate them for the risk. Currency risk represents the capital cost imposed on the lender by inflation over the period of a loan. This is important because inflation dilutes the value of a loan: if an investor anticipates a 10% return on an investment, a 10% depreciation in the value of the currency reduces that return to zero.

Sovereign bond yields are important because they typically constitute the ‘floor’ for funding conditions in the private sector. To the extent the sovereign possesses its own intrinsic currency or default risk, that risk is shared across the entire economy. For example, a country facing default may instead choose monetise the debt, inducing the central bank to increase the money supply and using devalued currency to pay back debtors in nominal terms. This has the effect of managing default risk by increasing currency risk: An investor may be paid back in nominal terms, but the return on the investment is proportionally diminished. As this affects all debts denominated in that currency, this raises the basic price of credit across the entire economy. A private borrower will therefore borrow at the rate of the sovereign, plus its own individuated default risk. Former ECB President Trichet explains:

‘Via the price channel, interest rates on government bonds influence financing conditions within the economy. For example, they are often used as a reference rate when a bank prices a loan for a customer, or when a company borrows money by issuing a bond. Sovereign

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1091 The main macroeconomic indicators used to assess default risk are government debt and deficits, and the BoP Moody's, Rating Methodology (2013); S&P, Rating Methodology and Assumptions (2013).
1092 Laubach (2009) (long-term treasury yields rise approximately 25bps per pp in the projected deficit-to-GDP ratio, and 3-4bps per pp increase in the debt-to-GDP ratio); Wyplosz, 'Dark sides' (2006), 225.
financing conditions, under normally functioning bond markets, often provide a floor for the funding conditions of the private sector.\textsuperscript{1093}

Prior to the introduction of the euro, the differences in macroeconomic fundamentals between countries led to starkly differentiated yields on long-term government debt. In 1992, long-term interest rates ranged from a high of 24.13\% (Greece) to a low of 7.36\% (Austria). From 1999, however – the year the Euro was introduced - spreads between government bonds had been reduced to zero. The markets considered government bonds to be near-perfect substitutes, with bond yields converging at a mean of 4.35\% (±0.14\%) (Figure 14).

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure14.jpg}
\caption{Nominal Interest Rates 1992-2012, \% per Annum\textsuperscript{1094}}
\end{figure}

This unprecedented nominal interest-rate convergence belied marked and persistent variations in underlying macroeconomic fundamentals of risk. Figure 15, for example, shows gross public debt and general deficit spending as a percentage of GDP. Traditionally, both measures are prime indicators of risk: They comprise over 50\% of fiscal risk assessments by rating agencies, and both are Maastricht convergence criteria.\textsuperscript{1095} Yet the data reveals marked and persistent divergences over the period of 1993-2008. Greece, Italy and Belgium never come close to complying with the 60\% of GDP gross debt limit; Greece and Portugal breach the 3\% of GDP deficit limit for the entire period of EMU; and Germany and France remain in breach from 2001-2006, and 2002-2005, respectively. There is no pattern of convergence similar to that of nominal interest rates.

\textsuperscript{1093} Trichet (2010).
A similar disconnect can be observed against a miscellany of keystone components of risk. Figure 16 divides the Euro countries into their Core and Periphery groups. It compares national wealth (typically accounting for at least 25% of a country’s economic strength rating), debt affordability (approximately 50% of a country’s fiscal strength rating), inflation (25% of a country’s institutional strength rating); competitiveness (about 17% of a country’s economic strength rating); and the current account balance (a ‘max risk indicator’ for credit ratings). It shows that, while long-term interest-rates merge, none of the key elements of macroeconomic risk do the same. The periphery group consistently lags in debt affordability, competitiveness, wealth and inflation, and accumulates a large current account deficit, while the core accrues increasing surpluses. In short, interest rates converge; macroeconomic risk indicators do not.

Figure 15 Maastricht Debt Indicators

<table>
<thead>
<tr>
<th>Consolidated Gross Gov’t Debt (% of GDP)</th>
<th>General Gov’t Deficit (% of GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Luxembourg</td>
<td>0%</td>
</tr>
<tr>
<td>Ireland</td>
<td>0%</td>
</tr>
<tr>
<td>Portugal</td>
<td>0%</td>
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<tr>
<td>Italy</td>
<td>0%</td>
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<tr>
<td>Greece</td>
<td>0%</td>
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<td>France</td>
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<td>Spain</td>
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<tr>
<td>Austria</td>
<td>0%</td>
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<tr>
<td>Poland</td>
<td>0%</td>
</tr>
<tr>
<td>Belgium</td>
<td>0%</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>0%</td>
</tr>
</tbody>
</table>


1099 S&P, Rating Methodology and Assumptions (2013), 3 considers GDP per capita to be its ‘most prominent measure’ of income levels in interest-rate assessments on government bonds. Moody’s, Rating Methodology (2013) gives GDP per capita a 25% weight in determining a country’s economic strength.


1101 Moody’s, Rating Methodology (2013) 3.

1102 A max risk indicator is a determinative risk factor capable of overriding all countervailing factors of any weight: Moody's, Rating Methodology (2013) 3; S&P, Rating Methodology and Assumptions (2013).
Figure 16  Nominal Interest Rate Convergence and Macroeconomic Risk Divergence

Panel 1: Interest-Rate Convergence
Long-Term Interest Rates, % per Annum

Panel 2: Interest-Rate Convergence
Short-Term Interest Rates, % per Annum

Panel 3: Debt Affordability
Interest Payments as a % of Revenue

Panel 4: Periphery Trade Deficit
Current Account Balance (% GDP)

Panel 5: Real Effective Exchange Rates

Panel 6: National Wealth
GDP Per Capita (Current LCU)

Panel 7: Inflation by GDP Deflator
(Weighted Aggregates)

Panel 8: Inflation by GDP Deflator
(Nominal Aggregates)

Other studies find a similar convergence in bond yields all across the yield spectrum, indicating that markets failed to react to idiosyncratic risk even where this entailed breaches of the SGP.\textsuperscript{1104} This is so despite the fact that business cycles did not become more aligned after EMU,\textsuperscript{1105} and nominal convergence did not eliminate country-specific shocks.\textsuperscript{1106} Ehrmann et al’s study of high-frequency bond yields is typical.\textsuperscript{1107} Before EMU, there are no cases where all bonds responded significantly to the same country-specific economic news; after EMU, there are no cases where government bonds react independently, even to idiosyncratic data. Ehrmann \textit{et al} marvel:

‘This is striking precisely because we are using daily data. There is not a single day after 1999 on which the two-year yield on government notes was noticeably different in one of the countries compared to the others.’\textsuperscript{1108}

### 3.1.2 The Interest Rate Channel and the Bailout Expectation

In the EMU, the complete elimination of interest rate spreads is the product of three mechanisms. First, the ECB accepted all government bonds on equal terms regardless of credit and inflation risk.\textsuperscript{1110} Under the interest-rate channel, this set a single price for credit at aggregate inflation and liquidity risk levels for the Euro.\textsuperscript{1111}

Second, under Article 7 of Directive 89/647/EEC and Annex I of Directive 93/6/EEC on capital adequacy (‘CRD’), any and all European sovereign bonds were assigned a default 0% risk weight, allowing banks to purchase unlimited amounts of government debt without holding any Tier 1 capital against it.\textsuperscript{1112} Ordinarily, investments in risky bonds or ‘risk-weighted assets’ (RWA), must be offset by burdensome capital-adequacy ratios that hinder leverage. For example, under Basel II, a claim on a sovereign with a Baa3 rating (i.e. Greece prior to entry to EMU) would attract a 50% risk


\textsuperscript{1105} Fabio Canova, Matteo Ciccarelli and Eva Ortega, ‘Similarities and convergence in G-7 cycles’ (2007) 54 J Monetary Econ 580 (finding that business cycles have not converged following EMU).

\textsuperscript{1106} Ehrmann and others (2011), 358.

\textsuperscript{1107} High-frequency bond-yields are a useful measure for bond convergence for because their short time horizon makes them susceptible cross-country arbitrage, and should therefore be highly reactive to small, idiosyncratic shocks See: Ehrmann and others (2011), 358.

\textsuperscript{1108} Ehrmann and others (2011), 358.

\textsuperscript{1110} Trichet (2010) explains: ‘We implement monetary policy by setting our key policy rates. Through this, we directly influence short-term interest rates in the money market. Financial markets transmit this impulse along the maturity spectrum, since term rates reflect current and expected future short-term rates as well as risk premia. These rates, in turn, affect the costs of funding for households, for firms, and for governments.’

weight.\textsuperscript{1113} This would require a bank to hold between 2\%-4\% of the total value of the claim in regulatory capital. But with a single face value set for all bonds by the ECB, and a universal 0\% risk-weight, the value of bonds became essentially the same - despite persistent variation in risk.\textsuperscript{1114}

These two legal instruments had the effect of giving all government bonds the same utility, supplanting actual country risk as the decisive determinant of value. Commercial banks could purchase higher-yield bonds that had, shortly ago, been Baa3 outside the Euro, and then deposit them at the ECB ‘as collateral for freshly-printed money’ on equal terms as AAA bonds.\textsuperscript{1115} The effect was an immediate increase in cross-border banking claims as banks surged to lend to Periphery countries in order to accrue extra basis points.\textsuperscript{1116} As a 2012 OECD report on the Euro admonishes, ‘the zero-risk weighting for sovereign debt in regulatory capital requirements does not accurately reflect risks.’\textsuperscript{1117} The Commission reaches a similar conclusion \textit{ex-post}:

‘conferring upon them [national bonds] the top-quality status require for central bank collateral [resulted in] strong yield convergence, considerably limiting market discipline, despite differences in national budgetary performances.’\textsuperscript{1118}

Third, markets ceased to price individuated credit risk along the maturity spectrum of sovereign bonds because markets (correctly) perceived the EMU as a joint-liability group and (correctly) assessed that the legal ‘no bailout’ rule in Article 125 TFEU was non-credible.\textsuperscript{1119} As explained by the President of the Federal Association of German Banks:

‘The markets never believed in the so-called "no- bailout" clause of the Maastricht Treaty, a clause that was designed to prevent euro-zone countries from being liable for the debts of other members. [They] were confident that “in an emergency, the strong countries would support the weak ones,” a view based on European politicians’ lax treatment of their own rules early in the game. Those who bought Greek bonds on a large scale at the time were betting that Europe’s statesmen would break their rules if a crisis came along.’\textsuperscript{1120}

Markets and ratings agencies were quite open about the reason for failing to price individuated default-risk into periphery bonds. In 1993, for example, Moody’s had assigned Greece a Baa3 credit


\textsuperscript{1114} EEAG, (2011), 80: ‘Theoretically, banks were allowed to leverage the loans given to the government sector infinitely... Even for loans to Greece, which had never enjoyed an AAA rating... banks had not been required to hold equity capital before the outbreak of the crisis.’


\textsuperscript{1116} George Soros, 'Remarks at the Festival of Economics' (Festival of Economics, Trento, Italy, 2 June 2012) <http://www.georgesoros.com/speeches/remarks_at_the_festival_of_economics_trento_italy/> accessed 4 October 2014.


\textsuperscript{1118} Commission Blueprint for a deep and genuine EMU COM(2012) 777 final, 3.

\textsuperscript{1119} Palmstorfer (2012), 777.

\textsuperscript{1120} Spiegel, 'The Ticking Euro Bomb' (5 October 2011).
rating (one notch above junk).\textsuperscript{1121} In December 1996, this was raised to Baa1 - despite a worsening external debt due to ‘the likelihood that the government’s efforts would eventually qualify the country to join the European Monetary Union.’\textsuperscript{1122} Then in July 1999 Greece’s credit rating was duly upgraded to A2.\textsuperscript{1123} The rating stated:

‘Moody's Investors Service has upgraded Greece's foreign currency country ceilings for debt and bank deposits to A2 from Baa1, \textit{in recognition of the high likelihood that Greece will soon qualify to join the single currency area} of the European Monetary Union (EMU). \textit{In accordance with Moody's methodology on the ratings of current EMU member governments}, Greece's probable entrance into the currency union indicates that the foreign- and domestic-currency government bond ratings should be merged at the level of the current A2 domestic currency rating.’\textsuperscript{1124}

The methodology report attached to the rating explained that the reason for the upgrade was a common credit-risk factor assigned to all EMU member governments.\textsuperscript{1125} The EMU was a joint-liability group.\textsuperscript{1126} Even before the Euro was issued, there was empirical evidence by the early 1990’s that ‘Membership in the EC itself is associated with a perceived increase in the probability of a bailout.’\textsuperscript{1127} This explained, for instance, why Greek membership in the EC allowed it to maintain comparable debt levels to those which caused financial crises in Mexico and Turkey.\textsuperscript{1128} Throughout the life of the euro, sovereign bonds yields ceased to be driven by idiosyncratic default-risk factors,\textsuperscript{1129} and market spreads showed more sensitivity to debt in countries outside the euro area than within it, signalling a widespread bailout expectation.\textsuperscript{1130} Californian bonds, for example,


\textsuperscript{1125} Moody's, 'Credit Risk Implications of EMU for European Sovereign Credits' (Moody's Investors Service, 1997).

\textsuperscript{1126} Sideek M Seyad, ‘A legal analysis of the European Financial Stability Mechanism’ (2011) 26 JIBLR 421, 422 argues that this upgrade is the reason that Greece was shortly able to ‘raise unlimited loans with soft interest rates ... by virtue of its membership in the Euroland’ and embark on a ‘debt fueled spending spree’.

\textsuperscript{1127} Xafa (1990): membership in the EC itself is associated with a reduction of risk premiums. Lane (1993) 64: ‘Membership in the EC itself is associated with a perceived increase in the probability of a bailout.’ Bovenberg, Kremers and Maason (1991), 379-382: increased cross-border exposures, political solidarity and general mutual interdependence would mean that the no-bailout clause ‘would not be fully credible.’

\textsuperscript{1128} Xafa (1990).


\textsuperscript{1130} Barry Eichengreen, 'The Breakup of the Euro Area' in Alberto Alesina and Francesco Giavazzi (eds), \textit{Europe and the Euro} (University of Chicago Press 2010), 51.
experienced a much greater differential from the US average than Greek bonds did from the EMU average, despite California enjoying a far better economic position relative to its fellows.\textsuperscript{1131} In 2005, Feldstein observed that markets had been led to ‘discount completely either the possibility that a Eurozone country would be unable to pay or the unwillingness of other EMU countries to come to its rescue if that should occur.’\textsuperscript{1132} In 2006, Blankart and Klaiber applied the well-trod principles of second-generation fiscal federalism theory (see Chapter 7) to conclude that Article 125 was not credible: ‘If an insolvency of a government were to happen now, the story is likely to end in a bailout with the help of the neighbouring governments.’\textsuperscript{1133} Five years into the life of the Euro, the \textit{Financial Times} reported:

‘In theory, the founding Maastricht treaty is clear that countries that cannot keep their public finances in order cannot expect to be bailed out by others or by the ECB. In practice, however… there has been little differentiation in a market that has tended to believe that there is an implicit guarantee of all euro-zone government debt.’\textsuperscript{1134}

\subsection*{3.1.3 Low and Negative Real Interest Rates}

Nominal interest-rate convergence resulted in a significant mis-pricing of the real cost of credit. This chapter selects the \textit{ex-post} real interest-rate measure to indicate the real cost of debt in the Periphery and Core countries.\textsuperscript{1135} The real \textit{ex-post} interest rate indicates the real yield (and real cost) of debt by factoring the impact of inflation on returns.\textsuperscript{1136} This is denoted by the Fisher equation \(i=r+\pi\), which states that the real cost of money \((r)\) is approximately the nominal interest rate \((i)\), minus inflation

\begin{footnotesize}
\textsuperscript{1131} Rodden (2006): There is no bailout expectation in US federalism.
\textsuperscript{1135} The \textit{ex-post} measure describes the real purchasing power of a loan. The \textit{ex-ante} rate is based on the expected inflation rate. The \textit{ex-post} measure is selected here because the literature suggests that lenders do not accurately price \textit{ex-ante} inflation, and so may be a less reliable indicator than the \textit{ex-post} measure, which provides a good account of expected returns where inflation trends are identifiable and predictable. See: Ehrmann and others (2011), 359; Heather Gibson, Stephen Hall, George Tavlas, 'The Greek financial crisis: Growing imbalances and sovereign spreads' (2012) 31 J Int Money Financ 498; Barnes (2010), 14. For a criticism see: ECB, \textit{Monetary Policy and Inflation Differentials} (2005), 70.
\end{footnotesize}
\[ (\pi), \text{ or: } (r = i - \pi). \]

If, for example, a firm can borrow at 4% \((i)\), and the inflation rate is 2% \((\pi)\), then the real cost of credit for that firm is 2\% \((r)\) or \((4 - 2\pi = 2)\).

According to the ‘Taylor rule,’ nominal interest rates must be set higher than inflation in order to turn a profit: A negative real interest rate of -1\% means that the lender issues €100 in order to receive €99 at maturity. Below Taylor-rule interest-rates are associated with a litany of distortive macroeconomic consequences. This is the essence of the ‘Walters Critique’ that informed the UK’s decision to remain outside of EMU. The Walters Critique predicted a damaging feedback cycle from below-Taylor rule interest rates under a single currency: A single interest-rate will result in low real interest-rates in countries with above-average inflation, inducing credit expansion, which further increases inflation, which further discounts real interest rates, which further increases credit expansion, and so on.

Figures 17-23 show ex-post real interest-rates for the Periphery and Core groups from 1993-2007. They demonstrate that, in 1993, the year of the entry into effect of the Maastricht Treaty, there was a substantial country-risk premium included in the price of credit: Inflation was higher in the Periphery countries, and lenders accounted for this in order to make a profit, resulting in above Taylor-rule rates \((i = r + \pi)\). So, for example, in Ireland in 1993, inflation \((\pi)\) was 5.2\%, and the short-term interest rate \((i)\) was 9.6\%, ensuring a real return \((r)\) of 4.4\% \((9.6\% - 5.2\% = 4.5\%)\).

As predicted by the Walters Critique, nominal interest rate convergence reverses this trend. The nominal interest-rate no longer accounts for the individual cost of inflation in the Periphery, and the real price of credit falls. Real long-term rates move significantly lower than the Core group beginning in 1996 and never rise above 2\%. Average short-term rates turn negative within two years of entry into EMU and never rise above zero until 2006. For nearly the entire existence of the euro until the crisis in 2007, the average real cost of credit in the Periphery group was better than nil -

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1137 Where \(i\) denotes the nominal interest rate, \(r\) denotes the real interest rate, and \(\pi\) denotes the inflation rate. This equation is used to denote the appropriate price of interest in order to account for inflation. Fisher (1896); Fisher, *Rate of Interest* (1907); Fisher, *Theory of Interest* (1930).


1141 Philip R Lane, 'The Irish Crisis' in Miroslav Beblavy, David Cobham and L’udovit Ödor (eds), *The Euro Area and the Financial Crisis* (Cambridge University Press 2011) 59, 75.

1142 ‘World Bank, 'Inflation by GDP Deflator (NY.GDP.DEFL.KD.ZG)' (2016); Eurostat, '3-month interest rates (irt_it_mcby_a; MAT_M03)' (2016).
debt was effectively subsidised by inflation.\textsuperscript{1143} The causal link between this condition and the remainder of this chapter is explained by the Commission as follows:

‘The result was strong yield convergence, considerably limiting market discipline, despite differences in national budgetary performances. ... Euro area economies in a cyclical expansion and with relatively higher inflation rates tended to enjoy low or even negative real interest rates. This led in some countries to strong credit expansion fuelling significant housing bubbles.’\textsuperscript{1144}

\textsuperscript{1143} Lane, 'Irish Crisis' (2011), 61.
\textsuperscript{1144} Commission Blueprint for a deep and genuine EMU COM(2012) 777 final, 3.
Figure 20  Real Interest Rates, 1993-2013, in % per annum: Greece

Figure 21  Real Interest Rates, 1993-2013, in % per annum: Portugal

Figure 22  Real Interest Rates, 1993-2013, in % per annum: Italy

Figure 23  Real Interest Rates, 1993-2013, in % per annum: Core Countries
3.1.4 Private Sector Credit Expansion

The result was an unprecedented credit boom. According to the IMF, the increase in household indebtedness in the Periphery group was, on average, 20 percentage points of GDP higher than the next eight comparable advanced-country credit cycles in history.\textsuperscript{1146} Lane explains:

“[T]he creation of EMU itself represented an asymmetric shock. In particular ... there was a substantial decline in interest rates for peripheral member countries such as Ireland, Portugal, Spain and Greece in the late 1990s. For these countries ... there [had been] a substantial country-risk premium in interest rates... Accordingly, EMU represented a major economic shock for them ... holding fixed other factors, households, firms and governments in these countries now faced a permanent reduction in the cost of capital. In turn, this triggered an expenditure boom in these countries.”\textsuperscript{1147}

\emph{Figure 24 Private Sector Credit Expansion}\textsuperscript{1148}

Figure 24 shows an unprecedented acceleration of private-sector credit growth in all of the crisis-hit periphery countries. In Ireland, the level of private credit increased over 165% from 1998-2009 (from 87.24% of GDP to 232%). Similarly, the level of private credit rose by nearly 150% in Spain from 1998-2009 (from 85.18% of GDP to 212.39%), and more than doubled in Portugal (from 89.24% to 186.78%). Greece experienced its largest booms slightly later due to its 2001 entry, but finished with the second-highest overall credit growth (114%, from 47.4% in 2000 to 94.28% in 2009). Italy’s credit growth is divided into two stages according to the period under which it experiences Core Group real interest rates. From 1997-2004, Italy experienced lower-than-Core or


\textsuperscript{1147} Lane, 'Irish Crisis' (2011), 75.

\textsuperscript{1148} World Bank, 'Domestic Credit to Private Sector (% of GDP) (FS.AST.PRVT.GD.ZS)' (\textit{World Bank Development Indicators}, 2014) <www.data.worldbank.org> accessed 26 November 2014. Panel 1 excludes: Luxembourg, Netherlands 1998, and France, Austria and Belgium in 1999 due to data unavailability. Panel 2: Percentage increase in domestic credit to private sector is relative to GDP. Core and Periphery averages are unweighted. Data for Luxembourg excluded due to lack of availability.
negative real interest-rates and its rate of credit growth (55%) is in line with the pattern of the Periphery cohort over that period. Then in 2005, Italy’s inflation fell to level of the Core cohort (implying positive real rates), and its rate of credit growth adopts average Core rate of expansion (of 25% from 2005-2009). The result is an overall increase of 66% (1997-2009), more than double the average Core increase (19.7%), but less than half the average Periphery increase (200%). As Italy demonstrates, low real interest rates operate as something of an on/off switch for credit expansion.\textsuperscript{1149}

3.1.5 Analysis: The Failure of the Prohibition on Financial Assistance

The root of the chain of causality in this section is the failure of Article 125 TFEU. The ‘no bailout’ rule was drafted to ensure that ‘the financial markets exercise a degree of discipline on any Member State by imposing differential terms on its paper and ultimately by refusing to lend.’\textsuperscript{1150} It failed. Markets (correctly) assessed that the ‘no bailout’ rule was non-credible, and (correctly) guessed that the EU would sooner re-write the Treaties than allow a Member State to default.\textsuperscript{1151} The EEAG concludes:

‘What is the main deficiency of Europe’s current economic constitution? To put it simply, markets found ample reason to disregard government defaults as a real possibility.’\textsuperscript{1152}

The literature on fiscal federalism provides two reasons for this failure, one economic and one institutional. First, the ‘no bailout’ commitment of the Member States themselves was not economically credible.\textsuperscript{1153} As early as 1991, IMF staffers argued that EMU would lead to immense cross-border spillovers, exposing private residents to foreign debt and creating irresistible pressure to bail out those investments \textit{ex-post}.\textsuperscript{1154} This is exactly what occurred. This time-inconsistency problem is plainly visible in the attitude of German officials towards bailing-out Greece, for example.\textsuperscript{1155} \textit{Ex-ante}, Germany pushed hard for the ‘no bailout’ rule at Maastricht, and, until the peak of the crisis, maintained its ‘no bailout’ stance.\textsuperscript{1156} Yet by 2008, German banks had invested

\begin{flushleft}
\textsuperscript{1149} It is also useful to note that the Netherlands experienced rapid credit expansion beginning in 2001, the year in which it, too, had negative or low real interest rates (from 2001): Fagan and Gaspar (2007), 5.

\textsuperscript{1150} See also, from the \textit{travaux préparatoires}, Monetary Committee, EMU Beyond Stage I (1990), 2; and Commission, ‘A stability Pact to Ensure Budgetary Discipline’ II/163/96-EN, 18 March 1996, 15-16: ‘This rule is designed to dispel any investor’s doubt, or hope, about the risk they run in financing governments that incur excessive deficits.’

\textsuperscript{1151} Maurice Adams, Federico Fabbrini and Pierre Larouche, 'The Constitutionalization of European Budgetary Constraints: Effectiveness and legitimacy in Comparative Perspective' in, \textit{The Constitutionalization of European Budgetary Constraints} (Hart Publishing 2014), 2: ‘speculators bet - successfully as it turned out - that the no-bailout clause would not ultimately stand.’

\textsuperscript{1152} EEAG, (2011) 80.

\textsuperscript{1153} See below, Chapter 7, Section 7.1.2. On the time-inconsistency of ‘no bailout’ rules, see: Rodden (2006). As Lane (1993), 64 explains, ‘Credibility depends not just on making a no-bailout commitment [ex-ante] but on the incentives to abide by this commitment [ex-post].’

\textsuperscript{1154} Bovenberg, Kremers and Maason (1991).


\end{flushleft}
nearly 50% of their GDP in claims on EMU-12 banks (see Figure 25).\textsuperscript{1157} Kirchhoff, and Bloomberg, separately point out that if Greece, Ireland, Portugal and Spain left the Eurozone, Germany would be left with around $704bn in debts resulting from those loans alone – an amount exceeding German banks’ entire aggregate capital.\textsuperscript{1158} As Hallerberg quips: ‘Explicit bans on bailouts usually appear in places where a “no-bailout clause” is not credible in the first place.’\textsuperscript{1159} The economic non-credibility of the no-bailout clause is a finding common to the assessments of IMF staff,\textsuperscript{1160} the OECD,\textsuperscript{1161} and the Commission.\textsuperscript{1162} An IMF Staff Discussion paper explains:

‘Article 125 TFEU—hereafter referred to as the “no bailout” clause—was meant to give financial markets an incentive to price default risk in a differentiated way across the euro area. However ... the clause lacked credibility: markets could extrapolate that the crisis in the affected countries would be deep and that spillovers would be substantial enough for policymakers to prefer to bail out a member country ex post rather than let it default. In other words, market discipline failed ex ante because the no-bailout option was not ex post credible.’\textsuperscript{1163}

This points to a second failure. It should be pointed out that this danger was not overlooked in the Treaty architecture. Unlike the EDP, the decision on whether to bail-out a debtor state was not left to a political mechanism. Article 125 TFEU is inscribed in European constitutional law (being Treaty-based) and, unlike the SGP, its enforcement is left to the ECJ – not elected governments. The ‘no bailout’ rule was not a choice; it was European constitutional law. The EU law itself was not credible. As Bishop forewarned in 1989, ‘The history of monetary unions suggests that the desire to build a nation has been a critical factor in determining the extent of central government assistance in a financial crisis.’\textsuperscript{1164} This has not proven a problem in the US,\textsuperscript{1165} Canada,\textsuperscript{1166} or Switzerland,\textsuperscript{1167} where federal courts jealously guard sub-federal spending and revenue autonomy. However, as

\textsuperscript{1157} See Figure 25, Section 3.2.1, p 171.  
\textsuperscript{1158} Bloomberg Editorial Board (2012). Gregor Kirchhof, ’Debt Limits in Constitutional Law: The “Debt Brake’” in Wolf-Georg Ringe and Peter M Huber (eds), Legal Challenges in the Global Financial Crisis: Bail-outs, the Euro and Regulation (Hart Publishing 2014) 53, 54: If Greece, Ireland, Portugal and Spain left the Eurozone, Germany would ‘be left standing with a three digit billion amount of debts resulting from this these loans alone.’  
\textsuperscript{1159} Hallerberg (2010), 132.  
\textsuperscript{1160} Bovenberg, Kremers and Maason (1991); Céline Allard and others, ’Toward a Fiscal Union for the Euro Area’ (IMF Staff Discussion Note, 2013) 9.  
\textsuperscript{1161} OECD, Euro Area 2012 (2012).  
\textsuperscript{1162} Commission Blueprint for a deep and genuine EMU COM(2012) 777 final, 3.  
\textsuperscript{1163} Allard and others, Toward a Fiscal Union (2013) 9.  
\textsuperscript{1164} Bishop, Damrau and Miller (1989).  
\textsuperscript{1165} See: Chapter 7, Section 7.2.3.  
\textsuperscript{1166} See: Chapter 7, Section 7.2.4, discussing Canadian jurisprudence on tax and spending powers, which tends to give primacy to Provincial heads of power and interprets them broadly. See: AG Canada v AG Ontario (Labour Conventions) [1937] AC 326, 354; [1937] 1 DLR 673 (Privy Council) per Lord Atkin, referring to Canada’s Provinces as ‘watertight compartments’; Hodge v The Queen (1883) 9 App Cas 117 (Privy Council); Liquidators of Maritime Bank v Receiver General of NB [1892] AC 437 (Privy Council).  
\textsuperscript{1167} See: Chapter 7, Section 7.2.2.
shown in above, EU institutions are widely seen to be pulled by a strong integrationist teleology.\footnote{See infra, Section 1.2.2.2, p 75.} According to the \textit{travaux préparatoires} at Maastricht, Europe’s historical experience of integrationist institutions meant that the Union simply could not be entrusted to enforce its own criteria for fiscal discipline in a debt crisis.\footnote{See infra, Section 2.3.1.4.} It was for this reason that Article 108 EEC was stripped from the Treaty in 1991 and replaced with a ‘no bailout’ rule in the first place.

Markets (correctly) bet that this teleology would drive EU institutions to violate its own rules rather than allow the default of a Member State, and this is precisely what occurred.\footnote{Adams, Fabbrini and Larouche (2014) 3: markets could plainly see that the Union would be ‘torn between a need to rely on market discipline … and knowledge that the consequences of such discipline might tear the eurozone apart.’} In May 2010 the Commission and the Eurogroup announced a €110bn package of bilateral loans to Greece, outside of EU law, with no legal justification save the ‘exceptional crisis for which the euro area was left with no remedial instrument.’\footnote{European Commission, ‘Reinforcing economic policy coordination’ (Communication) COM(2010) 250 final, 10. See also: Eurogroup, ‘Statement by the Eurogroup’ (Brussels, 2 May 2010) <http://www.consilium.europa.eu/uedocs/cmsUpload/100502-%20Eurogroup_statement-sn02492.en10.pdf> accessed 13 May 2014; Council Decision 2010/320/EU of 10 May 2010 giving notice to Greece to take measures for the deficit reduction judged necessary to remedy the situation of excessive deficit [2010] OJ L 145/6 amended by Council Decision 2010/486/EU of 14 September 2010 [2010] OJ L 241/12. For an analysis of the Greek mission and bailout package, see: European Commission, ‘The Economic Adjustment Programme for Greece’ (2010) European Economy Occasional Papers No 61.} This was followed shortly by the €440bn EFSF and €60bn EFSM,\footnote{Council of the European Union, ‘Press Release 9696/10: Extraordinary Council Meeting, Economic and Financial Affairs’ (Brussels 9-10 May 2010) ; EFSF Framework Agreement (2014) <http://www.efsf.europa.eu /efsf_framework_agreement_en.pdf> accessed 31 December 2014; EFSF Consolidated Articles of Association (23 April 2014) <http://www.efsf.europa.eu/EFSFStatusCoordones%2023AVRL2014.pdf> accessed 31 December 2014; Council Regulation 407/2010 of 11 May 2010 establishing a European financial stabilisation mechanism [2010] OJ L 118/1.} which were later recognised by the European Council and ECJ as wanting a proper legal basis before being folded into the €705bn ESM.\footnote{European Council Conclusions of 16-17 December 2010; Council Decision 2011/199/EU, rec 4.} The ESM then entered-into force before the Treaty amendment that was effected to provide it sufficient legal cover.\footnote{Pringle \& Ireland [116].} When this was challenged in \textit{Pringle v Ireland}, the ECJ upheld the ESM by adopting a teleological interpretation of the Treaty which, as shown in Sections 2.3.1.4 and Chapter 5, was thrice rejected at Maastricht.\footnote{See, infra Chapter 2, Section 2.3.1.4, p 134. The teleological interpretation in \textit{Pringle v Ireland} is discussed in depth below, Chapter 6, Section 6.4.3.} Pisani-Ferry explains:

‘Investors had read the treaty and were well aware of the fact that it excluded co-responsibility for public debt. But markets cold also remember all of the episodes in Europe’s history that had ended in improbably compromises, in other words, they did not see the so-called no-bailout clause as credible enough to fully price the risk of individual default.’\footnote{Pisani-Ferry, \textit{The Euro Crisis} (2011) 69.}
In sum, the EU’s model did not fail because it ‘placed too much faith in markets,’ rather, it placed too much faith in the naivety of markets to ‘accept the no-bailout clause at face value.’

3.2 Macroeconomic Imbalances and the Failure of the MSP

The second phase in the chain of causality is the failure of the MSP to account for, and still less to prevent, unprecedented macroeconomic imbalances stemming from the failure of the prohibition on financial assistance. The unprecedented capital flows which followed interest-rate adjustment in the Euro are acknowledged as the ‘most important’ cause of the crisis by DG ECFIN. This has four components: [3.2.1] Cross-border credit flows precipitated by low real interest-rates; [3.2.2] current account imbalances and net external indebtedness in the Periphery; [3.2.3] competitive divergence; and [3.2.4] information asymmetries built into the MSP itself.

3.2.1 Cross-Border Credit Flows

The effect of low real interest-rates on capital flows well-established in the literature. On the demand side, a drop in interest-rates reduces the cost of inputs, increases the amount of productive capital available to firms, increases firm market values, and raises output expectations. Put simply, borrowers who can borrow cheaply are worth more to investors. Boris et al. for example, finds that accession to EMU caused a 17.1% increase in Q-ratios (the market value of a firm relative to the total value of assets) in the Periphery.

On the supply side, lower financing costs increases investment in capital, and investment in capital then increases anticipated growth trajectories, or potential output, raising the optimum amount of investment for lenders. At country level, convergence or ‘catching up’ theory predicts a trajectory

\[1177\] Adams, Fabbrini and Larouche (2014). 2. See also Herdegen (1998), 26, predicting the Community would ‘yield to pressure to rescue a member State unable to serve its government debts.’ See also Jonathan Rodden, ‘Can Market Discipline Survive in the US Federation?’ in Paul E Peterson and Daniel Nadler (eds), The Global Debt Crisis: Haunting US and European Federalism (Brookings Institution Press 2014), 45: if officials found it politically impossible to enforce its own debt rules, ‘how could it possibly summon the political fortitude to allow them to default?’ See further: Charles Wyplosz, ‘EMU: why and how it might happen’ (1997) 11 J Econ Persp 3, pointing out that in 1997 that Germany itself had argued that the no-bailout clause would not prove ‘fully credible.’ Boone and Johnson (2010) predicting the Portuguese bailout (for which they were later sued by Portugal) is typical: ‘European Union money will be there for anyone who wants it.’


\[1181\] A Q ratio is a method for evaluating the value of a company, consisting of the market value of a company divided by the replacement value of the firm’s assets. Based on the hypothesis that the value of all companies should be approximately equal to their replacement costs, a Q-ratio above 1 implies that a firm’s stock is overvalued. A 17.1% increase in Q-ratios indicates a 17.1% increase in the likelihood of overpriced valuations. Arturo Bris, Yrjö Koskinen, Mattias Nilsson, ‘The Euro and Corporate Valuations’ (2009) 22 Rev Financ Stud 3171. See also Lieven Baele and others, ‘Measuring Financial Integration in the Euro Area’ (2004) ECB Occasional Papers No 12.

of growth based on the distance between actual and potential output levels.\textsuperscript{1183} The starting output of poorer countries will tend to be lower because they have less productive capital and lower multifactor productivity than rich countries. A drop in financing costs allows the country to remedy this disadvantage, purchasing more capital to increase productivity, thus ‘catching up’. According to the so-called ‘Rose effect’, financing will flow from wealthy countries to poor countries where the rates of return are now higher as a result of steeper potential output trajectories.\textsuperscript{1184}

In the EMU, where there is no inflation or liquidity-risk built into the cost of credit, this process is amplified through two channels: The balance sheet channel and the bank lending channel.\textsuperscript{1185} The balance-sheet channel is the mechanism by which interest rates affect the net worth of borrowers: As external credit premiums are inversely related to a borrower’s net worth, a higher net worth from lower financing costs accelerates borrowing and investment decisions.\textsuperscript{1186} Put simply, borrowers who can borrow more cheaply can borrow larger quantities.

The bank-lending channel is essentially the balance-sheet channel applied to banks: An increase in the supply of bank funding increases the amount of loans a bank can make. Ordinarily, the traditional role of the banking sector is intermediation between investors and savers: Banks collect savings through deposits, and then transform those deposits into loans to match the needs and risks of that economy.\textsuperscript{1187} In that traditional role, banks are subject to the national liquidity constraint: They are simply unable to lend significantly more than they take in in deposits and revenues within the country. However an open capital market vastly increases the amount of funding available, at a time when negative interest-rates make them more profitable investments for foreign banks.\textsuperscript{1188} In Ireland, for example, the Nyberg Report found that rapid loan growth in the banking sector could not have been financed by domestic deposits – it was financed on international wholesale markets.\textsuperscript{1189} Figure 25 shows that between 1999-Q2 and peak, the inter-bank credit-to-GDP ratio from EMU-12 countries increased by approximately 283% in Ireland, 217% in Spain, 166% in Greece, 187% in

\begin{itemize}
  \item Andrew K Rose, 'One money, one market: the effect of common currencies on trade' (2000) 15 Econ Policy 9.
  \item Ben Bernanke, Mark Gertler, 'Inside the Black Box: The Credit Channel of Monetary Policy Transmission' (1995) 9 J Econ Persp 27.
  \item Alfredo Martin-Oliver, 'Financial Integration and Structural Changes in Spanish Banks During the Pre-Crisis Period' (2012) 24 Estabilidad Financiera 111, 113.
  \item As Barnes, Lane and Radziwill (2010), 11-12, observe, under this feedback channel ‘even a relatively modest increase in the external holdings of a large country can dramatically increase the size of funds available to a small deficit economy.’ See also: Emine Boz, Enrique G Mendoza, 'Financial Innovation, the Discovery of Risk and the US Credit Crisis' (2014) 62 J Monetary Econ 1.
\end{itemize}
Portugal, and 127% in Italy.\footnote{1190} Peripery bank ceased relying on deposits, as foreign capital flowed into them.\footnote{1191}

Negative real interest rates add a perverse acceleration to this cycle. This is so because financial institutions typically spend about 5% of endowment assets per year, and so they must make 5% in earnings after inflation.\footnote{1192} But in an environment of negative real interest rates, ‘safe’ investments lose purchasing power: A negative real interest rate of -1% means that the lender knowingly issues €100 in order to receive €99 at maturity.\footnote{1193} As a result, fixed-income investments and other safe assets actually detract from annual returns.\footnote{1194} Negative real rates incentivise banks to increase their exposure to risk because they are required to do so in order to make a profit. Numerous studies point to a decline in lending standards and increased risk exposures over the course of the Euro.\footnote{1195}

The growth rate of the balance sheet of Anglo-Irish bank, for example, exceeded 20% in eight of nine years between 1998 and 2007, with an annual growth rate of 36% (annual balance-sheet growth rates of 20% or more are usually taken as the trigger for regulatory scrutiny).\footnote{1196} Across the Union, the leverage ratios of the 10 largest EU banks increased from 28% to nearly 45% between 1994 to 2006.\footnote{1197}

This acceleration is heightened by competition from foreign banks in low-inflation countries (where real rates are positive) who may happily make 5% off ‘safe’ borrowers.\footnote{1198} So, for example, in 2002-
Q2, German-resident banks (where inflation was 1.43% and real interest rates were 1.89%) had leant the equivalent of 7% of Irish GDP to Irish-resident banks (where inflation was 5.5%, and real short-term interest rates were -2.19%).\footnote{200} For threatened Periphery banks, since real short-term interest rates on their own borrowings are nil, the quickest way to make 5% in real returns is to access short-term interbank loans at little (or zero) real cost and issue longer-term loans for a profit - a technique which creates a dangerous mismatch in the maturity of funding and lending.\footnote{201}

In sum, low or negative real interest rates subsidise the optimal amount of debt (for borrowers) and leverage (for creditors): Exposure to inflated assets increases the book value of banks and property-related collateral, which increases the availability of wholesale financing, justifying further credit expansion, in turn feeding back into rising asset values, which increases the book value of banks, and so on.\footnote{202} This increases inflation, further discounting real interest rates, and fuelling the inflationary spiral predicted by the Walters Critique.\footnote{203}

Excessive credit growth is a leading predictor of financial crises.\footnote{204} Numerous studies chart a direct correlation between the depth and severity of the banking crisis and the pace and scale of credit expansion in the preceding period.\footnote{205} Under the Euro, cross-border interbank loans leaped from 22% of total interbank loans in 2000, to 34% in 2008, and short-term interbank funding increased 2,800%.

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2009: Nature, Causes, and Reactions’ 13 J Int'l Econ L. 531. See also: Leuthold (1981); Perold (2012) (noting that lenders do not raise their minimum level of interest rates to account for real inflation, they simply increase risk).

\footnote{200}{See: Figure 25, p 131. See also: Ryan (2011), 40.}

\footnote{201}{This technique was responsible for several notable bank failures during the financial crisis: Editorial, ‘Why Northern Rock was doomed to fail’ The Telegraph (London 16 September 2007) <http://www.telegraph.co.uk/finance/markets/2815859.html> accessed 26 November 2014. See also: Lane, McQuade (2013), 2.}


\footnote{203}{Barnes, Lane and Radziwill (2010), 4: ‘The pace of borrowing in several deficit countries was extremely high due to low real interest rates, financial deepening, optimistic growth expectations and financial accelerator mechanisms... Credit expansion in deficit countries financed excessive saving-investment gaps and fuelled consumption, housing and asset price booms.’ The ECB observed precisely this effect in 2005: ECB, Monetary Policy and Inflation Differentials (2005), 70. See also: Filippo Altissimo, Michael Ehrmann, Frank Smets, ‘Inflation persistence and Price-Setting Behaviour in the Euro Area’ (2006) ECB Occasional Papers No 46.

\footnote{204}{Oscar Jordá, Mortiz Schularick, Alan Taylor, 'When Credit Bites Back: Leverage, Business Cycles and Crises' (2011) Federal Reserve Bank of San Francisco Working Paper No 27 (a study of 14 developed countries over 140 years) is typical: ‘Our overall result is that credit growth emerges as the best single predictor of financial instability.’ See also: Mortiz Schularick, Alan Taylor, 'Credit Booms Gone Bust: Monetary Policy, Leverage Cycles and Financial Crises' (2012) 102 Am Econ Rev 1029; Pierre-Olivier Gourinchas, Maurice Obstfeld, 'Stories of the Twentieth Century for the Twenty-First' (2012) 4 Am Econ J 227.


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- from 0.1% to 2.9%. Among Europe’s largest banks, 82% of Deutsche Bank assets were foreign, as were 64% for Santander, 62% for UniCredit, 41% for BNP Paribas, and 29% for Société Générale.

Figure 25 investigates cross-border consolidated claims from the EMU-12 (excluding Luxembourg) on the five Periphery countries, plus their largest Core creditors (Germany, France and the Netherlands). Consolidated banking claims represent exposures of banks by nationality, according to the residence of a bank’s head office. The cumulative bars represent the total value of claims on each host state (credit inflows), while the triangle markers represent the opposite: the sum of claims by the state on EMU-12 banks (credit outflows). So, for example, if a German bank purchases a bond from an Irish bank, the value of this claim as a percentage of Irish GDP will add to the cumulative bar in Germany’s assigned colour in ‘Panel 1: Ireland’; and its value as a percentage of German GDP will be represented in the height of the triangle marker in ‘Panel 7: Germany.’

The sheer scale of credit flows from Core to Periphery in the EMU is staggering. By the onset of the crisis, the banking sectors of France and Germany alone had flooded Ireland with claims worth 130% of its entire GDP by 2008-Q2, and 30% each of Italian, Portuguese, Greek and Spanish GDP by 2009. Greek, Portuguese and Spanish banking sectors were all subject to foreign claims accounting for over 70% of their respective GDP. Total outflows from the Core were proportionally immense: German, French and Dutch foreign claims amounted to over 40%, 60% and 130% of their GDP, respectively. In all five Periphery countries, inward claims from Germany and France alone exceeded the total value of outward claims on the entirety of the EMU-12. As a Bloomberg editorial observes: ‘irresponsible borrowers can’t exist without irresponsible lenders.... By December 2009, German banks had amassed claims of $704 billion on Greece, Ireland, Italy, Portugal and Spain, much more than the German banks’ aggregate capital. In other words, they lent more than they could afford.’

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1206 Barnes, Lane and Radziwill (2010), 12.
1208 Luxembourg is excluded from the comparison due to data unavailability.
1209 This captures both the domestic operations of national banks, as well as the foreign subsidiaries of domestically-owned national banks. They exclude intragroup positions, and so do not show international transactions within a bank of a single nationality. It captures only exposures to unaffiliated counterparties from other countries. See: Patrick McGuire, Philip Wooldridge, 'The BIS consolidated banking statistics: structure, uses and recent enhancements' (2005) BIS Quarterly Review September, 73; BIS, 'Consolidated banking statistics: Foreign claims by nationality of reporting banks, immediate borrower basis' 2014) <http://www.bis.org/statistics/constats.htm> accessed 27 November 2014.
1211 Barnes (2010), 7.
Figure 25  Consolidated Banking Claims by Country, as % of National GDP

Panel 1: Claims on Ireland as % of Irish GDP
- Spain
- Portugal
- Italy
- Austria
- Netherlands
- Belgium
- France
- Germany
- Irish Claims on EMU-12 Banks (Total)

Panel 2: Claims on Spain as % of Spanish GDP
- Portugal
- Italy
- Ireland
- Austria
- Netherlands
- Belgium
- France
- Germany
- Spanish Claims on EMU-12 Banks (Total)

Panel 3: Claims on Greece as % of Greek GDP
- Portugal
- Spain
- Italy
- Ireland
- Austria
- Netherlands
- Belgium
- France
- Germany
- Greek Claims on EMU-12 Banks (Total)

Panel 4: Claims on Portugal as a % of Portuguese GDP
- Italy
- Ireland
- Austria
- Netherlands
- Belgium
- France
- Spain
- Germany
- Portuguese Claims on EMU-12 Banks (Total)

Panel 5: Claims on Italy as % of Italian GDP
- Spain
- Portugal
- Ireland
- Austria
- Netherlands
- Belgium
- France
- Germany
- Italian Claims on EMU-12 Banks (Total)

Panel 6: Claims on the Netherlands as % of Dutch GDP
- Italy
- Spain
- Portugal
- Ireland
- Austria
- Belgium
- France
- Germany
- Dutch Claims on EMU-12 Banks (Total)

Panel 7: Claims on Finland as % of Finnish GDP
- Italy
- Spain
- Portugal
- Ireland
- Austria
- Belgium
- France
- Germany
- Finnish Claims on EMU-12 Banks (Total)

Panel 8: Claims on Greece as % of Greek GDP
- Portugal
- Spain
- Italy
- Ireland
- Austria
- Netherlands
- Belgium
- France
- Germany
- Greek Claims on EMU-12 Banks (Total)

1213 All panels exclude Luxembourg due to data unavailability. All panels exclude 1999-Q3 due to data unavailability. All panels exclude Ireland to 2006 due to data unavailability. Panel 1: Greece, Finland, excluded as all amounts = <1%. Irish claims on foreign banks exclude the following due to unavailability: Finland (all periods) and Greece and Portugal from 2006Q1-2006Q4. Panel 2: Austria, Finland and Greece excluded as all amounts = <1%. Panel 3: Finland excluded as all amounts = <1%. Panel 4: Greece and Finland excluded as all amounts = <1%. Panel 4: Finland, Greece, Portugal excluded as all amounts = <1%. Panel 5: Italian Claims on EMU-12 banks exclude the following due to data unavailability: Austria 2001Q4-2004Q4; Finland 2001Q4; Greece 2001Q4-2007Q2; Netherlands 2001Q4-2005Q1; Portugal 2001Q4-2002Q1. Panel 6: Finland, Greece, Portugal excluded as all amounts = <1%. Panel 7: Finland, Greece, Portugal excluded as all amounts = <1%. Panel 8: Austria, Finland, Greece, Portugal excluded as excluding as all amounts = <1%. Bank for International Settlements, (2014)
3.2.2 Current Account Imbalances and Net External Indebtedness

The distortionary effect of credit expansion on periphery economies is difficult to overstate. Figure 26 shows the evolution of current account surpluses in EMU countries as a percentage of GDP. The gulf which emerged between Core and Periphery under the Euro is unprecedented in over thirty years of economic data. Beginning in 1993, the year of the Maastricht Treaty, the current accounts of both core and periphery groups were roughly in balance: Neither group sold nor borrowed significantly more than the other, and both groups were, on average, net exporters to the world. As real interest-rates fell in the periphery, the average current account of the periphery group began to deteriorate precipitously, while the core accrued increasing surpluses.

Figure 26 Current Account Balance as % of GDP: Periphery Countries vs the Core

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1214 The current account is the sum of a country’s balance of trade. A positive current account balance indicates that the country is a net seller of products to the world, while a negative current account balance indicates that it is a net purchaser. A country which is unable to make to sell abroad and is dependent on external products will deplete its national income.

1215 Panel 1: Current account balance as % of GDP from the first year of the Euro to the first full year of the crisis. Core weighted average excludes Luxembourg due to data unavailability. Panel 2: Core weighted average excludes Luxembourg due to data unavailability. IMF, ‘Current Account Balance, % GDP’ (2016).
The root of this reallocation is a breakdown in the role of credit in the financial system under low real interest-rates.\textsuperscript{1216} From a theoretical perspective, the role of the finance system may be decomposed into five fundamental functions: Effective payments, mobilisation of funds, pooling of risk, appraisal of creditworthiness, and monitoring the use of funds.\textsuperscript{1217} Of these, the latter two functions are determinative of competitiveness. This is so because creditors will demand a higher premium from businesses with higher probability of failure, ensuring that credit is restricted to productive investments. Inefficient businesses unable to afford this premium will be forced to exit the market. In essence, what matters for growth and competitiveness is not just the availability of large amounts of credit, but the effectiveness and quality of that credit.

Where credit is universally cheap and abundant, however, it does not play its normal ‘watchdog’ role in the economy.\textsuperscript{1218} In a currency union with a bailout expectation there is, in effect, a ‘de-linking’ between the cost of credit and conditions of domestic production at national level.\textsuperscript{1219} Non-productive borrowers in the Periphery may access international credit through domestic banks at the same real cost (or lower) as highly-productive firms in the Core. Unlike those productive firms, however, the non-tradable domestic borrower may not contribute to the output expectations necessary to pay back the cost of the investment.\textsuperscript{1220} In 2006, for example, the Irish Central Bank Governor warned that ‘the watchdog role [of credit] has been muzzled by the arrival of the single currency, so the financing, currently of mortgage demand, has persisted further than it would have in the past.’\textsuperscript{1221} The OECD notes: ‘there is a powerful feedback mechanism between domestic weaknesses in credit quality and the overall availability of credit.’\textsuperscript{1222}


\textsuperscript{1219} In the Euro Area, Jürgen von Hagen and Boris Hofman, 'Macroeconomic implications of low inflation in the euro area' (2004) 15 N Amer J Econ Finan 5 and Boris Hofman and Hermann Reumsperger, 'Inflation Differentials among the Euro Area Countries: Potential Causes and Consequences' (2005) 16 J Asian Econ 403 confirm that it is the euro-area interest rate which is determinative for aggregate demand. See also: Lane and Milesi-Feretti (2010), 100; Barnes (2010), 10.

\textsuperscript{1220} Lane and Pels (2012): ‘optimistic growth expectations can lead to current account deficits without any link to economic convergence.’

\textsuperscript{1221} Honohan, 'To What Extent?' (2006), 60.

\textsuperscript{1222} OECD, Euro Area 2012 (2012) 31.
Echoing the Walters Critique, empirical work by Mendoza and Terrones studying 70 credit booms in 61 countries found that credit booms are common under managed exchange rates, and have a systemic relationship with boom-bust cycles in asset prices, real inflation, balance of payment imbalances, and banking crises. Fagan et al. formalise the effects of the drop in interest rates on a small periphery country and confirm the result is a private-sector consumption boom, real appreciation, upward pressure on wages, and external trade imbalances. In the EMU specifically, numerous studies confirm that interest-rate convergence caused severe current-account deteriorations, gaping negative net-foreign asset outlays, and unprecedented build-ups in household debt. Fagan and Gaspar summarise the commonalities of the Periphery experience so adroitly that it is worth repeating here:

‘The process of interest rate convergence was accompanied by a boom in final expenditures of households … in the converging countries. This was accompanied by a sharp rise in the household debt ratio. Non-housing investment also increased in relative terms but the differences across country groups were not as sizeable. In contrast, fiscal balances were remarkably similar across the two groups of countries. Overall output growth differentials, however, did not increase. The boom in domestic expenditure fuelled by credit growth triggered a deterioration in the current account balance and a build-up of foreign debt. In addition, the converging countries experienced a sizeable real appreciation vis-a-vis the core group.’

It should be emphasised that the external debts mapped in this section are simply not a public-sector phenomenon. Contrary to the official wisdom, Fagan and Gaspar find little difference in the aggregate balances of Core and Periphery governments. Similarly, Lane finds out that ‘households were the primary borrowers in Ireland and corporations in Spain, with the property boom fuelling debt accumulation in both countries.’ The rapid credit expansion, flagging competitiveness and next external indebtedness of the periphery economies must be, as Gavilán et al.

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1226 Fagan and Gaspar (2007), 14 (emphasis added). See also: Giavazzi and Spaventa (2011), 211: ‘The intuition behind this result is quite simple. Insofar as non-tradable goods by definition can only be consumed domestically, foreign financing for their production is equivalent to borrowing abroad for consumption purposes.’
1227 Where the Core is anyways indebted than the Periphery: Fagan and Gaspar (2007), 14, chart 13.
1228 Lane, ‘European Sovereign Debt Crisis’ (2012), 54.
conclude, ‘rationalised as the natural reaction of the [private] economy to the observed developments in interest rates.’

3.2.3 Reallocation to Non-Tradable Consumption and Competitive Divergence

Although unprecedented in scale, the essential tenets of this process are well-known. Credit expansion has a deleterious effect on competitiveness as demand in the non-tradable sector draws away capital from efficient investments in the tradable sector with higher output potential. The result is not only external indebtedness, but a significant real appreciation in the Periphery and long-term competitive divergence.

Conceptually, each country’s economy can be divided into a tradable sector, which sells outputs abroad and is subject to international productivity competition; and a non-tradable sector, which does not sell on the international market and is less exposed to international productivity competition. The productive, tradable sector produces goods which are sold on the international market, which in turn generates taxable income and increases the balance-of-payments of the country. The non-tradable sector absorbs resources but does not contribute to the net income of the country. The Irish housing sector provides a ready example of the latter: Housing investment is particularly sensitive to real interest rates, yet when two Irish residents build and swap houses, the money exchanged doesn’t add to the country’s balance-of-payments with the world. Instead, there is an indirect real appreciation from the transaction, as the increase in economic activity hires away capital from the tradable sector.

If the tradable sector wants to bid it back, it will have to pay more. This causes real exchange-rate appreciation. Reis summarises the causal connection with interest-rates thusly:

‘A fall in the interest rate at which a country can borrow from abroad causes a consumption boom and large capital inflows to finance it, so that net foreign assets fall. The higher consumption of tradables is sustained through imports, whereas nontradables must be produced


1230 See, generally: Mendoza and Terrones (2012); Reinhart and Rogoff (2011); Reinhart and Reinhart (2008); Fisher (2003); Obstfeld (1998); Rogoff (1999); Summers (1998); Calvo (1998); Milesi-Feretti and Tille (2011).


domestically. This requires a reallocation of inputs into the nontradables sector, and with it an increase in employment in that sector, an increase in real wages, and a real appreciation.\textsuperscript{1234}

This effect is widely visible in the periphery countries. The OECD finds that ‘export-oriented activities became squeezed by over-heating domestic demand,’ as credit inflows went ‘to fund consumption or loss-making property investments.’\textsuperscript{1235} The overall share of industry and manufacturing to gross value added declined sharply in the periphery countries, while construction and services in the non-tradable sector expanded.\textsuperscript{1236} Mayer explains:

‘[B]elow the surface of the euro area’s public debt and banking crisis lies a balance-of-payments crisis caused by a misalignment of internal real exchange rates… the Eurosystem generates real resource transfers, in the form of subsidised credit, from the creditor to the debtor countries.’\textsuperscript{1237}

Figure 7 shows real the effective exchange rates (REER) of the Periphery countries against the Core group (unweighted average) from 1993 (Maastricht), and the percentage increase/decrease for all countries to 2007 (the last year before the crisis). It shows an average real appreciation of 10% in the Periphery group and an average real devaluation of 1.3% in the Core group. Between 1993 and 2007, nominal interest rate convergence (and real interest rate divergence) meant that Periphery products had become, on average, 11% more expensive than the core.

\textit{Figure 27 Real Effective Exchange Rates}\textsuperscript{1238}

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\textsuperscript{1234} Ricardo Reis, 'The Portuguese Slump and Crash and the Euro Crisis' (2013) 46 Brookings Papers on Economic Activity 143, 162.

\textsuperscript{1235} OECD, \textit{Euro Area} 2012 (2012), 35, 74. See also: Fagan and Gaspar (2007), 5; Lane and Pels (2012).

\textsuperscript{1236} OECD, \textit{Euro Area} 2012 (2012), 76; Philip R Lane, 'The Real Effects of European Monetary Union' (2006) 20 J Econ Persp 47 (finding that inflation divergence between Core and Periphery was led by inflation growth in non-tradables).

\textsuperscript{1237} Mayer (2011), 2.

\textsuperscript{1238} REER is the nominal effective exchange rate (NEER) index, adjusted for relative movements in national price or cost indicators of the home country, selected countries and the euro area. A NEER index is the ratio (here expressed on the base 1993=100) of an index of a currency’s period-average exchange rate to a weighted geometric average of selected competitor currencies. World Bank, 'Real effective exchange rate (PX.REX.REER)' (2014).
3.2.4 Analysis: The Failure of the Multilateral Surveillance Procedure

In 2001, the Lisbon Strategy was launched to make the EU ‘the most competitive and dynamic knowledge-based economy in the world’ by 2010. Yet by the end of the Euro’s first decade, the OECD reported that the damage done to the net foreign asset positions of Greece, Ireland, Portugal and Spain under the Euro was far larger than the OECD norm at any time since WWII. A range of empirical work finds that the deficits accumulated in the Periphery far exceeded the potential increase in national wealth capable of financing them. Put simply, on a staggering scale, capital flows were financing investments in Periphery countries that would never generate the output needed to pay it back.

The question then necessarily arises: Where was the European Union? Under Articles 121 and 126 TFEU, the EU’s latitude to monitor and coordinate in economic policy is extremely broad, ‘potentially encompassing any national economic policy and thus reaching every aspect of economic activity in the Member States.’ Under Article 121(4) TFEU, if Member State economic policies were based on a misjudging of economic fundamentals, or risked ‘jeopardizing the property functioning of economic and monetary union’ EU institutions were expected to identify them and raise the alarm. And yet, as Adamski concludes:

‘It is hardly disputable that the pre-crisis macroeconomic coordination of structural reform policies... failed to raise the alarm on deteriorating competitiveness of peripheral countries and growing bubbles on assets markets. It failed even more badly at reducing them.’

EU surveillance assessments prior to the crash make surprising reading. For example, mere months before Ireland’s fatal €375bn bank guarantee, the Commission’s EMU@10 report hailed the EMU as ‘a major success,’ mis-attributing Periphery current account deficits to an ‘accelerated

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1240 As early as 2002, Blanchard and Giavazzi (2002), 167 found that financial liberalisation had effects on the current account that were not linked to any future increase in returns. Lane, ‘Capital Flows’ (2013), 9 notes that the ‘expansion in net imbalances during 2003-2007 cannot be easily linked to the convergence mechanisms,’ but rather ‘gross capital flows (especially gross debt flows) and “risk on” conditions in global financial markets.’ See further: Florence Jaumotte, Piaporn Sodiriviboon, ‘Current Account Imbalances in the Southern Euro Area’ (2010) IMF Working Paper No 139 (capital flows not justified by potential output); Giavazzi and Spaventa (2011) 201 (the deficits accrued not justified by output expectations); Gavilán and others (2011) 91 (‘The path of productivity growth which would be required to justify the current account deficits accumulated during this period was, indeed, substantially above the rate of growth of productivity’); von Hagen and Hofman (2004); Hofman and Reinsberger (2005) (the euro-area interest rate was determinative for aggregate demand); Favero, Pagano, von Thadden (2010) (sovereign yields corresponded to a single factor of aggregate risk, despite liquidity differentials displaying very significant heterogeneity and no common factors); Kristen Forbes and Francis E Warnock, 'Capital Flow Waves: Surges, Stops, Flight and Retrenchment' (2012) 88 J Int Econ 235 (the time series of gross capital flows was determined by international liquidity conditions - not domestic ones).
1242 Art 6(2), 10(1) Reg 1466/97
1243 Adamski, 'National Power Games' (2012), 1351.
catching-up process’ and remarking the strong performance of Spain, Ireland and Greece.

This only to find, a year later, that any gains in economic growth had been completely ‘wiped out’ by macroeconomic imbalances which reached ‘an all-time high’ as the EMU@10 report was written. The Economist fairly points out that the Commission’s forecasts for 2008 - when the financial crisis was already front page news - had the euro area growing at 2% in 2008 and 1.8% in 2009 (the final numbers were -0.3% in 2008 and -2.8%). Ionnou and Stracca find strong and robust evidence that ‘neither the Stability and Growth pact nor the Lisbon Strategy have had a significant beneficial impact on fiscal and economic performance outcomes.’ Others point out that EU officials appeared wilfully blind to the growing imbalances in the euro area. Warner concludes:

‘Until the beginning of the euro crisis in 2009 EU officials tended to ignore the current account imbalances among EMU member countries … [and] even insisted that these imbalances were irrelevant.’

A central issue in the literature is explaining how the current account deficits in the Periphery grew so far beyond the capacity of national economies to finance them, evidently without detection. Applying basic lessons of fiscal federalism theory to the findings of Giavazzi and Spaventa, Blanchard and Giavazzi, this section concludes that the failure of the MSP is the failure of EU institutions to detect the violation of the solvency condition in the absence of the liquidity constraint.

Ordinarily, the Commission’s assumption that current-account deficits are part of an ‘accelerated catching-up process’ is unproblematic: According to traditional convergence theory, a ‘catching up’ country may experience a higher current account deficit before a big catch-up, on the anticipation that this will be matched by future export surpluses. Except, ordinarily, there are two forces which prevent a current account deficit from progressing from a ‘natural side effect of a healthy process of convergence’ to ‘symptoms of future sovereign insolvency.’ These are:

**The inter-temporal budget constraint** (or the solvency condition) is the notion that present liabilities must be compensated by future surpluses and international investment gains – a condition otherwise known as solvency. Compliance with the inter-temporal budget constraint requires that, first, credit is put to productive purposes which will generate future income to

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1246 Commission, *EMU@10* (2008).
1248 Buttonwood, ’The perils of planning on the basis of economic forecasts’ The Economist (26 November 2015).
1249 Demosthenes Ionnou, Livio Stracca, ’Have the euro area and EU governance worked?’ (2014) 34 Eur J Polit Econ 1.
1251 Giavazzi and Spaventa (2011).
1252 Blanchard and Giavazzi (2002).
1253 Blanchard and Giavazzi (2002), 149; Giavazzi and Spaventa (2011) 201-203’[F]oreign borrowing is optimal for a converging country: the recommended level of external borrowing is higher … the greater the country’s expected output growth relative to the area average.... Persistent current deficits are thus a physiological effect of their catching up process.’
1254 Giavazzi and Spaventa (2011) 201-203.
pay it off, and, second, that credit expansion slows and ceases as the economy approaches the limit of its potential output. As shown above, this condition was violated under the single interest-rate. Credit was not put to productive purposes and interest-rates did not rise as Periphery countries approached, and then exceeded, potential output.

The liquidity constraint is the effect of dwindling stocks of money on interest rates. When growth is funded domestically, potential output has a clear limit: the stock of national savings to finance it.\textsuperscript{1255} In a country with limited liquidity and no bailout expectation, investors can be assumed left to their devices: Dwindling stocks of money appreciate in value, borrowers experience rising interest premiums, and only efficient firms are able to access increasingly expensive credit.\textsuperscript{1256} There is a natural ‘crowding out’ of consumptive borrowing as pools of credit are absorbed and become increasingly expensive, and creditors which bear the cost of default will become increasingly discerning as the country approaches the limit of its potential.\textsuperscript{1257} As Gibson observes, ‘this liquidity effect is so widely recognised... that it might be called the reigning view on the relation between money and interest rates.’\textsuperscript{1258}

Put simply, investors will cease pouring money into an economy which will no longer generate the returns needed to pay it back. In the Euro, however, credit remained perfectly elastic in response to consumptive demand because there was no ‘crowding out’ from higher risk premiums - despite above-average inflation and deteriorating output potential.\textsuperscript{1259} Giavazzi and Spaventa explain:

‘Models establishing the optimality of a success of current account deficits in a catching-up process implicitly assume that the inter-temporal budget constraint is satisfied, so that the accumulation of foreign liabilities is matched by future surpluses... [T]he growth pattern of the countries under consideration was unsustainable because it violated the solvency constraint: the counterpart of the capital inflows was a boom of non-tradable residential construction or a growth of consumption. While monetary union removed the external constraint in the short


\textsuperscript{1256} On the interaction of liquidity and interest rates, see: Gibson (1970), 434-345; Tobin, 'Liquidity Preference' (1947); Latané (1954); Friedman (1959); Meltzer (1963); Cochrane (1989); Leeper and Gordon (1992)

\textsuperscript{1257} Bernanke and Gertler (1995).

\textsuperscript{1258} Gibson (1970), 435.

\textsuperscript{1259} For example, from 2002 to 2009, Germany’s aggregate savings amounted to €1,621bn. Of this, only one-third (€562bn) was invested at home and two-thirds (€1,058bn) was exported to third countries. Approximately 4/5 of this export was financial investment, while only 1/5 was direct investment. See: EEAG, (2011) , 77; Barnes (2010), 11. For an explanation of the theoretical background, see: John Marcus Flemming, 'Domestic Financial Policies Under Fixed and Under Floating Exchange Rates' (1962) 9 IMF Staff Papers 269.
run, a common monetary policy targeting the average inflation rate of the area did nothing (nor could it do much) to prevent the extraordinary growth of credit that fuelled the growing imbalances in the countries under consideration. As our analysis shows, these are indeed fault lines in the construction of the single currency which, previously hidden, became visible under the impact of the world financial crisis.  

It is here where fiscal federalism theory provides answers to why this was not detected by supranational institutions. There is, at institutional level, a significant principal-agent and information asymmetry problem. Multilateral surveillance suffers from what Pisani-Ferry calls ‘streetlamp syndrome’: EU surveillance shines its light down on top level general government balances, but is twice removed from groundswell economic movements underpinning those balances. Oates explains:

‘Local governments, so the argument goes, are closer to their constituencies; they have a superior knowledge of the preferences or demands of local residents and of other local conditions (e.g., cost functions). It is difficult for a central authority to determine the particular preferences of the residents of the myriad of decentralized jurisdictions that make up the nation as a whole. Thus, there exists an asymmetry of information: local governments know the preferences of their own residences and other local circumstances, but the central government does not.’

If interest-rates do not rise in response to country risk, all of the ‘symptoms of future insolvency’ are local phenomena. They are not found in the general government balance. They are they are found on the balance-sheets of regional banks; in above-equilibrium house prices in Madrid; in a hotel construction boom in Dublin; in rising car imports in Greece, and myriad other idiosyncratic booms across thousands of European townships. From the view of supranational institutions, beneficial capital flows are seen to flood into credit-worthy Periphery banks. Only 5% of loans to the non-

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1260 Giavazzi and Spaventa (2011) 201-208
1262 Oates (2005), 35.
1264 Oates (2005), 35.
1265 Cordon and Neary (1982); Barnes (2010), 12; Fagan and Gaspar (2007); Lane, 'International Financial Integration' (2010); Lane, 'Capital Flows' (2013).
1266 Barnes (2010): the ending of the catching-up phase can therefore be ‘difficult to identify contemporaneously particularly when domestic demand is booming and the overall growth of the economy remains strong.’
banking sector were issued directly from foreign banks, and it is worth noting that the lenders with the most toxic exposures to periphery bonds were Spanish Cajas and German Landesbanken – regional banks that will not be under EU supervision even once the ‘Banking Union’ is created.\(^{1267}\) All the symptoms of insolvency spilling out into the Member States are local.\(^{1268}\) For this reason, the EU and other international institutions proved no better, and in many cases much worse, than national authorities at detecting symptoms of insolvency.

Local authorities, on the other hand, are well-placed to perceive and respond to local information from markets and electorates (which levy their costs on national institutions directly). But as long as credit-supply conditions are unresponsive to regional risk, there is nothing to be done about them. Giavazzi and Spaventa attribute unsustainable asset bubbles in the periphery to precisely this disconnect.\(^{1269}\) Credit supply conditions pre-determined on a Union-wife basis; they are incapable of responding to them.

The collapse of the Irish banking sector is elucidative. Three reports commissioned in the wake of the crisis point to two causes, one domestic and the other European.\(^{1270}\) On the (international) supply side, overleveraging was the result of unresponsive interest-rates and credit flows which exceeded the entire GDP of the state. On the (domestic) demand side, the crisis was caused by exposure to, and then the collapse of, the domestic property bubble. Yet imbalances in the housing sector were well-prodded by Irish economists and regulators.\(^{1271}\) By 2003, the academic consensus in Ireland was that housing prices had overshot equilibrium and would fall, triggering recessionary pressures.\(^{1272}\) Financial Stability Reports during the 2004-2006 period considered a range of potential overvaluations, from 55% to 73%.\(^{1273}\) Stress tests were undertaken by the Irish Central Bank and the

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\(^{1268}\) Vitor Constâncio, ‘European Monetary Integration and the Portuguese Case’ in Detken, Gaspar and Noblet (eds), The New EU Member States: Convergence and Stability (Third ECB Central Banking Conference, ECB 2005) 204, 211: In the absence of the liquidity constraint, ‘The balance of payments is no longer an autonomous macro-monetary restriction, but is instead the result of the borrowing requirements of domestic agents conditioned by their own budget constraints.’

\(^{1269}\) Giavazzi and Spaventa (2011) 216.


Financial Services Regulatory Authority of Ireland in 2004 and 2006, accounting for up to a 20% fall in housing prices. Some commentators considered the stress-tests inadequate, however, the actual fall in existing house prices between 2007 and 2008 was 7.79% - well below the stress test levels. Local regulators were also aware that Irish banks’ external funding had increased from 20% of GDP in 2003 to 41% in 2005. Demand-side shocks were highly expected, so why was the crisis not averted?

Put simply, international credit-supply conditions responsive only to Euro aggregates (on the supply side) supported proportionate imbalances on the demand side. The IMF concluded that ‘even a substantial withdrawal of private sector deposits would not exhaust the stock of liquid assets at any major lender.’ The OECD concluded that ‘Irish banks are well capitalised and profitable and should have considerable shock-absorption capacity.’ Both the OECD and the IMF praised Irish regulators. Similarly, ‘EU Council Opinions were favourable [and] did not focus very strongly on vulnerabilities arising from monetary conditions.’ This was so even though Irish financial stability assessments did flag risks in the rise of credit and property prices. In short, Hand-wringing by national regulators over domestic imbalances was met with the response that Irish banks now sat perched atop an international credit pipeline gushing twice the volume of the national economy, and would remain responsive only to euro aggregates.

The causa sine qua non of the failure of multilateral surveillance is, once again, the disconnection of credit prices from macroeconomic fundamentals prevailing at national level. Supranational

1277 The new international funding conditions were considered by bankers and regulators to be ‘permanent’ (Regling, 2010, 20) and ‘a new global norm’ (Nyberg, (2011) 2). So long as the flow of credit at EMU interest rates was not in jeopardy on the supply side, so neither were exposures on the demand side. Barret and others, ‘Medium-term review’ (2005) 93 for example, modelled a 33% decline in housing prices, but predicted that ‘the government’s borrowing would not rise’ in spite of the shock, and so would remain sustainable.
1281 Regling, (2010), 20.
1283 See, e.g., IMF, Financial Sector Assessment Report: Ireland (2006) 11: ‘heavy reliance on wholesale funding potentially increases liquidity risk. As shown ... however, the off-shore funding is diversified.’
1284 Commission Blueprint for a deep and genuine EMU COM(2012) 777 final, 3.
institutions are simply less-well placed to perceive local signals from markets and electorates about the character of interest-rate adjustment, and they are anyways unable to respond to them. Local authorities are well-placed to do both, but as long as credit-supply conditions are unresponsive to regional risk, there is little to be done about them.

Studies testing alternative economic policy explanations for the crisis fail to find any other causal relationship which explains the correlation between interest rates, capital flows, and net external indebtedness.\textsuperscript{1285} Member State economic policies make little difference to the result. Empirical work by Rose and Spiegel, for example, fails to find any pre-crisis economic policy determinant that is a satisfactory correlate to the decline in economic performance in periphery countries – other than interest rates.\textsuperscript{1286} Barnes, and Barnes et al., respectively, attribute the phenomena specifically to the distortions in the international credit cycle caused by low real interest rates.\textsuperscript{1287} Portes argues that the distinguishing feature of the 2008 euro crisis from other (less severe) historic crisis is the effect of low real interest rates and undisciplined capital flows.\textsuperscript{1288} Garicano \textit{et al} conclude:

‘Although there are alternative explanations for the euro crisis, the view that the credit bubble itself is the source of the disturbance is hard to counter…. Our reading of the evidence is thus that the causality mainly runs from the credit bubble to the real changes and not in the opposite direction.’\textsuperscript{1289}

3.3 The European Sovereign Debt Crisis and the Failure of the EDP

The final failure of the Maastricht architecture is the failure of the excessive deficit procedure to prevent the sovereign debt crisis – its \textit{raison d’etre} - and, more fundamentally, to enforce budgetary discipline on its own terms.\textsuperscript{1290} This section identifies a number of reasons for this, but primary among them is that the Euro Crisis was a private debt crisis, not a public one.\textsuperscript{1291} Compliance with the SGP does not change this pattern of causality traced in this chapter because general government debt is not a significant predictor of the sovereign debt crisis at all - real interest rates and private-sector credit are. As Skouras concludes:

\textsuperscript{1285} Fagan and Gaspar (2007), 28.
\textsuperscript{1287} Barnes (2010), 11; Barnes, Lane and Radziwill (2010). See also: Hamid Faruqee and Jaewoo Lee, 'Global Dispersion of Current Accounts: Is the Universe Expanding' (2009) 56 IMF Staff Papers 574.
\textsuperscript{1288} Richard Portes, 'Global Imbalances' in Mathias Dewatripont, Xavier Freizes and Richard Portes (eds), \textit{Macroeconomic Stability and Financial Regulation: Key issues for the G20} (CEPS 2009).
\textsuperscript{1289} Jesús Fernández-Villaverde, Luis Garicano and Tano Santos, 'Political Credit Cycles: The Case of the Eurozone' (2013) 47 J Econ Persp 145, 146.
\textsuperscript{1290} Commission Blueprint for a deep and genuine EMU COM(2012) 777 final, 2: ‘The SGP was insufficiently observed by the Member States and lacked robust mechanisms to ensure sustainable public finances.’
\textsuperscript{1291} Economist, 'The euro crisis was not a government debt crisis' (2015).
‘Consequently, it is difficult to accept that the euro zone’s problem is excessive sovereign debt. This official diagnosis misses the root of the crisis.’

3.3.1 Not a Sovereign Debt Crisis

Figure 28 compares the aggregate trajectories of gross government debt with domestic credit to the private sector, both measured in % of GDP. The result is startling. Contrary to the official wisdom, the gross debt accumulations leading to the crisis accrued all but entirely in the private sector. While Periphery country debt-to-GDP ratios fell by an average of 20% between Maastricht and the crisis, Periphery private-sector debt increased by an approximate average of 150% over the same period. It is this pattern which binds the crisis-hit periphery countries and distinguishes them from the core. As the IMF concludes:

‘The roots of the financial crash stretch back to the preceding seven years of low interest rates and high world growth. […] Low interest rates … pushed up asset prices, from stocks to housing prices. Low interest rates and limited volatility prompted a search for yield and underestimation of risks led to the creation and the purchase of ever riskier assets. […] Fiscal policy did not play a major role in the run up to the crisis.’

Figures 29-33 examine this claim in further detail by decomposing public and private-sector debt accumulation by country. Even in Greece (Figure 31), the proximate cause of the crisis must be traced to the private sector: In that country, government debt increased just 11% over fifteen years

1292 Skouras (2013).
1295 All aggregates are unweighted averages unless otherwise stated. ‘Credit Crisis Arrives’ denotes August 9, 2007, when BNP Paribas froze redemption funds for three investment funds citing an inability to value certain structured products, signalling the arrival of the US credit crisis in Europe. Panel 1: Eurostat, 'Government consolidated gross debt (gov_10dd_3dpt1)' (2016). Panel 2: World Bank, 'Domestic Credit to Private Sector (% of GDP) (FS.AST.PRTV.GD.ZS)' (2014). Core average and % increase for 1998 excluded due to data unavailability. Core average for 1993 and 1999 excludes Luxembourg due to data unavailability.
(2003-2008), while private sector debt increased by a whopping 249%. In Ireland (Figure 30) the gross government debt/GDP ratio fell a remarkable 73% between 1993-2007 (from 94% to 25% of GDP), while private sector credit expanded 359%. In that country, the composition of foreign assets grew to 1,700% of GDP. All of the Periphery countries exhibit the same pattern: As the 2012 OECD survey, the 2010 Commission reform initiative, and the 2013 IMF Consultation conclude, the European ‘sovereign debt’ crisis was caused when private-sector debt migrated to the public sector through bank recapitalisations, the collapse of revenues, and fiscal stabilisers. Private debt - not public debt - is the proximate cause of the sovereign debt crisis. Huber concludes:

‘Let us not get it wrong. The sovereign debt crisis did not start with Greece and its roots are not public debt, at least not directly.’

Figure 29. Gross Government Debt vs Private Sector Domestic Credit (% of GDP): Periphery

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1297 Private sector credit increased from 43.55% to 199.17%. The sum of external assets reached 1700%, where the normal average sum of external assets and liabilities in industrial countries is approximately 330% of GDP: Lane, Milesi-Feretti (2010) 100; Honohan, 'To What Extent?' (2006), 64.
1300 IMF, 2013 Art IV Consultation (2013), 58: ‘In the boom phase, the private sector... increased their indebtedness while governments were able to reduce debt. As the private sector entered the deleveraging cycle, debt “migrated” to the public sector - through bank recapitalization or debt financed fiscal demand support.’
1301 IMF, 2013 Art IV Consultation (2013), 58; Caruana and Avdjiev (2012), 71, 80; Mody and Sandri (2012), 206.
1302 See: Lane, 'European Sovereign Debt Crisis' (2012), 54: ‘The credit boom in this period was not primarily due to government borrowing.’ Barnes (2010), 31: ‘private sector imbalances have been the major driver over the past decade’. See further: Richard Vague, The Next Economic Disaster: Why It’s Coming and Hose to Avoid It (University of Pennsylvania Press 2014).
1303 Kurt Hübner, 'Eurozone: Creeping Decay, Sudden Death or Magical Solution' in Fin Laurson (ed), The EU and the Eurozone Crisis (Ashgate 2013), 26.
1304 Aggregates calculated as unweighted averages. 1993-2008 % Increase, is average percentage increase over 1993 levels. Eurostat, 'Government consolidated gross debt (gov_10dd_3dpt1)' (2016); World Bank, 'Domestic Credit to Private Sector (% of GDP) (FS.AST.PRVT.GD.ZS)' (2014).
3.3.2 The European Sovereign Debt Crisis

The ‘sovereign debt crisis,’ properly so named, refers to but the final link in the chain of causality: The rise in sovereign bond spreads beginning in August 2007 and the inability to refinance government debt on financial markets (see Figure 34). This phase of the crisis unfolded in two stages. The first ‘financial’ stage of the crisis – the *causa proxima* - occurred when the disruption of credit markets in 2007 reverberated through the banking sector, causing a credit-supply shock which began to unravel the credit-fuelled imbalances built up under the Euro. The second, ‘sovereign debt’ phase of the crisis emerged in 2008 as the feedback loop which led to interest-rate convergence reversed flow and banking sector risks travelled upwards to sovereign bonds, resulting in a sovereign-bank debt feedback loop.

As will be shown, the EDP is not merely ineffective at intervening in this cascade – it is incapable of doing so. Perhaps even worse than that, it is procyclical: The EDP deactivates when countries were ‘temporarily boosted by tax-rich activity’ from ‘unsustainable booms,’ and is then unable to penalise crisis-hit countries in recessions once the booms have collapsed. Criticism of the ‘stupid’ SGP for this reason are well-trod. However what matters for this thesis is the inability of the SGP to do what it says it does: Prevent excessive deficits.

The crisis began with the arrival of the US subprime crisis on European shores in August 2007, when BNP Paribas froze redemptions on three funds citing an inability to value certain structured products. As banks found themselves unable to value each other’s (and their own) exposures, counterparty risk increased dramatically, and interest-rates rose. The balance-sheet and bank-lending channels were thrown into reverse: Unable to determine which among them was credit-worthy and which contained a vault of poisoned assets, inter-bank funding markets seized, causing a liquidity crisis, and banks began to deleverage. Mortgage-backed securities and other property assets could not be used as collateral, highly-leveraged Periphery banks could no longer take short-

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1306 Lane, ‘European Sovereign Debt Crisis’ (2012), 55; Von Hagen, Schuknecht, Wolswijk (2011); Mody and Sandri (2012); Caruana and Avdjiev (2012), 71, 79.
1308 BBC, ‘Row over “stupid” EU budget Rules’ BBC (17 October 2002) <http://news.bbc.co.uk/2/hi/business.stm> accessed 14 December 2014. See also: Barry Eichengreen, ‘After the Stability Pact’ (Berkeley University, 2014) <http://eml.berkeley.edu/~eichengr/reviews/die-zeitnov20-03.pdf> accessed 14 December 2014: ‘its credibility and good name have been hitched to a 3 per cent deficit ceiling that is at best silly and at worst perverse.’
term loans at negative or negligible rates, and the tottering imbalances in the Periphery began to crumble.\footnote{House prices fell by approx. 1/3 in Ireland, 1/4 in Spain, and 1/5 in Greece by 2012: OECD, 
\textit{Euro Area} (2012), 32.}

\textbf{Figure 34} \textit{The Sovereign Debt Crisis: Interest Yields on Long-Term Government Bonds}\footnote{Eurostat, 'EMU convergence criterion series - monthly data (online data code irt_ltmcb_my)' (Eurostat, <http://epp.eurostat.ec.europa.eu>) accessed 26 November 2014.}

While Member States had managed to comply nominally with the SGP leading to accession, the structural deterioration which built-up within the SGP meant that fiscal balances began to fail at the first downturn in revenues.\footnote{Approximately two-thirds of the pre-accession increase in the revenue-to-GDP ratio was reversed: Morris, Ongena and Schuknecht (2006), 16. Six Member States moved immediately excessive deficits, beginning with Portugal (in 2001 and 2005), followed by Germany (2002), France (2002), Greece (2003), Netherlands (2003), and Italy (2003).} The EDP failed to account for revenues from asset bubbles, which made them structurally unsound in the event of a correction in external funding.\footnote{Paolo Biraschi and others, 'The New Medium-Term Budgetary Objectives and the Problem of Fiscal Sustainability After the Crisis' (2010) \textit{Analisi e Programmazione Economico Finanziaria Working Papers} No 8.} In the event, retrenchment of cross-border credit flows was immense: At its peak, the volume of gross capital flows in the Euro Area amounted to over 40% of GDP (an extreme amount in relation to other advanced economies). The contraction was equally unprecedented – credit flows fell to just 5% of GDP in 2008-2009.\footnote{Core countries withdrew investment from periphery countries in an order of magnitude of -71.2% of GDP in Ireland, 20% in Greece, 18.1% in Spain, 17.4% in Portugal, and 15.3% in Italy: IMF, \textit{Euro Area: Selected Issues} (2013), 4. Cross-border bank holdings constituted the largest transmission vehicles of shock in the sovereign debt crisis: Carlo Favero, Alessandro Missale, 'EU Public Debt Management and Eurobonds' in European Parliament Committee on Economic and Monetary Affairs (ed), \textit{Euro Area Governance - Ideas for Crisis Management Reforms} (European Parliament 2010) 102.} Ireland moved into recession in Q2-Q3 2007. Greece and Italy followed in
Q3-Q4 2007. All of the EMU-12 would be in recession by the end of 2008. The second, ‘sovereign debt’ phase of the crisis emerged in 2008. Cracks began to show between government bond yields with the nationalisation of Northern Rock (UK) in January 2008, and the rescue of Bear Stearns (US) in March 2008. The ‘sovereign debt crisis’ only truly emerged, however, following the announcement of the €375bn bank guarantee by the Irish government (a commitment amounting to well over twice GNP) in October 2008, followed closely by nationalisation of Anglo Irish Bank in January 2009 (at a cost equivalent to 20% of Irish GDP). These guarantees signalled the risks for governments with large private-sector external debts, and it is there where the separation between the Euro crisis and government finances ended. Pisani Ferry explains:

‘Investors, who had already been woken up from their indolence by the global financial crisis, reran their calculations and concluded that Greek debt was considerably more risky than German Debt... Spreads between ‘good’ and ‘bad’ borrowers started to widen across the euro area. Ireland, where the astronomical cost of saving the banks was becoming apparent, was the first victim. It was soon followed by Portugal, where the absence of growth fuelled doubts about the country’s ability to repay its debts.’

By March 2009, Periphery spreads over German bonds had widened to 274bps for Ireland, 285bps for Greece, 144bps for Italy, 166bps for Portugal, and 101bps for Spain. As sovereign bond values began to deteriorate, the balance-sheet channel returned shocks back downwards to banks, resulting in a ‘self-reinforcing negative spiral.’ Sovereign debt write-downs led to write-downs on bank balance-sheets, which increased doubts about the sovereign’s ability to support them, leading to sovereign write-downs, and so on.

1321 Empirical work by Caceres, Guzzo and Segoviano (2010) and Mody and Sandri (2012), 204 find that from January 2009, the driver of sovereign bond yields expanded from financial sector risk towards governments facing refinancing risk.
1322 Pisani-Ferry, The Euro Crisis (2011) 8. See also: Hinarejos, 'Limits to Fiscal Integration' (2014) 245: ‘Once the markets paid more attention to the individual macroeconomic fundamentals, they started to have doubts as to specific countries’ credibility as debtors.’
1324 Under the 0% risk weight for Periphery bonds, Periphery banks had become heavily exposed to their sovereigns, and governments were increasingly priced against whether they could bear the cost of supporting their stricken financial institutions. Niccolo Battistini, Marco Pagano, Saverio Simionelli, 'Systemic Risk and Home Bias in the Euro Area' (2013) European Economy Papers No 494. Skouras (2013), 53 argues that this was aggravated in November 2008, when
In the midst of this spiral, Greece announced that its debt data had been mendacious for years, and issued a revised deficit forecast of 12.7%, in October 2009 - double the existing estimate of 6%.\textsuperscript{1325} It is this revelation to which the mischaracterisation of the ‘sovereign debt crisis’ is owed.\textsuperscript{1326} Pisani-Ferry laments that, had Ireland sought a bailout first, ‘the focus of the discussion on European crisis would have been completely different’ – focused on cheap credit and macroeconomic imbalances - not cultural failings. The Irish, he adds, ‘are not known for spending too much time on the beaches.’\textsuperscript{1327}

Following the announcement, foreign claims on the public sectors of Greece, Ireland, Italy, Portugal and Spain dropped from €586bn in the third quarter of 2009, to €335bn mid-way through 2011 - a fall of approximately 42%.\textsuperscript{1328} Greek bonds began to peel away from Irish bonds immediately, causing it to seek €110bn in assistance by May 2010.\textsuperscript{1329} Portuguese and Irish bond yields rose together in 2010, resulting in Ireland seeking €85bn in assistance in October and Portugal following-suit for €78bn in April 2011. Italian and Spanish spreads rose over 400 basis points over the level of Germany in 2012, resulting in Spain seeking €100bn in assistance to bail out its banks.\textsuperscript{1330}

This final result, the ‘sovereign debt crisis’ properly so-named – the raison d’être of the EDP. Yet EDP is as irrelevant to this cascade of imbalances as it was to its creation.\textsuperscript{1331} For example Portugal, the first country to incur an excessive deficit, undertook adequate austerity measures in response to a 2002 Council Recommendation, and the procedure was abrogated by the Commission in April 2004.\textsuperscript{1332} Yet less than a year later, the planned deficit reached over 6% of GDP and Portugal came under a second EDP which lasted until 2008.\textsuperscript{1333} Similarly, Ireland and Spain were praised for their budget surpluses in 2007, only to have that praise rendered irrelevant by the collapse of private-

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European finance ministers announced that no further systemic financial institutions would be allowed to fail, followed by a declaration from the German Chancellor that the guarantee would be exercised by each European state individually.\textsuperscript{1326} ‘Report on Greek Government Deficit and Debt Statistics’ (Communication) COM(2010) 1 final. The 12.7% figure was subsequently revised upwards to 15.4% of GDP. See further: Gibson, Hall and Tavlas (2012), 504; Lane, 'European Sovereign Debt Crisis' (2012), 56.

\textsuperscript{1326} Lane, 'European Sovereign Debt Crisis' (2012), 56.

\textsuperscript{1327} Pisani-Ferry, The Euro Crisis (2011) 52.

\textsuperscript{1328} Caruana and Avdijev (2012), 71, 81.

\textsuperscript{1329} Greek bonds ultimately rose to over 29% until it received a second bailout of €130bn in February 2012.

\textsuperscript{1330} Lane, 'European Sovereign Debt Crisis' (2012).

\textsuperscript{1331} Feust and Peichl (2012): ‘if the member states had agreed to procedures and sanctions against individual member states, it is unlikely that this would have prevented the current government debt crisis.’


\textsuperscript{1333} Commentators are quick to point out that the reason for this was not government mismanagement – it was a necessary response to Portugal’s abbreviated boom-bust cycle in the private sector: Reis (2013), 173; Pedro Lourtie, ‘Understanding Portugal in the Context of the Euro Crisis’ (Resolving the European Debt Crisis Conference, Bruegel, Chantilly, September 13-13, 2011) <www.piie.com/publications/papers/lourtie20110913.pdf> accessed 24 November 2014; Constâncio (2005).
sector credit imbalances: By 2011, Ireland’s debt had risen from 25% to 108% of GDP and Spain’s from 40% to 70%. As Giavazzi and Spaventa observe,

‘It is sobering to recall the praise lavished on Ireland and Spain for the deficit and debt performance... the stability of the EMU depends on a wider set of conditions than compliance with budgetary discipline.’

By the time the crisis arose, the EDP became worse than useless. As Adams et al. point out, sanctions are ‘ill-suited to the situation of member states that would find themselves unable to bring their deficit and debt under control.’ Crawford, Trichet, and Christine Lagarde make similar points: The EDP is ‘virtually unusable when it comes to sanctions.’ The EDP was designed to build fiscal buffers to deal with small idiosyncratic shocks of up to 2% of GDP - it was never capable of (nor was it intended to) counter the dysfunctional credit incentives which led to the Euro crisis.

### 3.3.3 The Futility of Centralised Fiscal Governance: A Counterfactual

The statement of this chapter is that the sovereign debt crisis is the culmination of an economic breakdown that began with a mispricing of credit – not fiscal profligacy. The necessary implication is that centralised fiscal governance, failed or otherwise, is irrelevant to the cascade traced in this chapter (if not an aggravating factor). For the extinguishment of doubt, this conclusion is verifiable with a brief counterfactual – that is, could any alternative fiscal policies have been adopted to cause or prevent the cataclysmic accumulation of external debt in the Periphery?

The answer, according to several critiques, is no. First and most obviously, the chain of causality identified in this chapter is not capable of running in reverse (from sovereign debt to macroeconomic imbalances, etc.). Ordinarily, governments affect the composition of external debt through several instruments: Capital controls (restricting capital inflows or outflows), trade policy (targeting sector-specific inflows/outflows), monetary policy (interest rates and base money), and fiscal policy (affecting the rate of domestic absorption). Under EMU, the first two are banned and the third is the exclusive competence of the Union, fixed at Euro aggregates. That leaves fiscal policy. But fiscal

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1334 Pisani-Ferry, 'Streetlamp syndrome' (2011).
1338 Rosa Maria Lastra, 'Systemic risk, SIFIs and financial stability' (2011) 6 CMLJ 197: ‘What makes a crisis of a systemic nature is not so much the trigger (causa proxima) but these transmission mechanisms, domestically and internationally.’
policy cannot cause (nor is it correlated with) the phenomena of real low interest-rates, unprecedented credit expansion, capital flows, and private sector indebtedness mapped in this chapter. Real interest rates are, in fact, ‘a monetary phenomenon’ - not a fiscal one.\textsuperscript{1340} They are a function of inflation, and inflation is a function of nominal interest-rates and capital flows (over which Member States have no control in EMU). Constraining the current account is ‘well beyond direct policy influence’ in an open-market currency union.\textsuperscript{1341}

The best fiscal policy can do is attempt to dampen absorption, however, even then it is not clear that fiscal policy is capable of affecting absorption in the private sector at all – and certainly not on the scale required to combat broken credit incentives.\textsuperscript{1342} The evidence is that the relationship between the primary budget and the current account is exceedingly weak: Abbas et al. find that a 1\% of GDP increase in the fiscal balance will increase the current account by a mere 0.2-0.3\% of GDP.\textsuperscript{1343} When one recalls that capital flows from France and Germany alone were 120\% of Irish GDP, for example, the futility of trying to replace failed credit incentives with centralised fiscal governance becomes obvious. The scale of fiscal tightening required to offset the ‘monetary phenomenon’ of real low interest rates would exceed the entire national income of entire countries.\textsuperscript{1344} For this reason, a 2002 OECD Economics Department Working Paper argued that fiscal policy should \textit{not} be used to counter private sector credit expansion, since the scale of public sector spending needed to dampen demand would undermine budgetary stability (and that is if it is not futile altogether).\textsuperscript{1345} An IMF working paper on exchange-rate stabilisation operations in Greece, Ireland Portugal and Italy emphasises that there is no relation in any of those countries between fiscal policy and disinflation.\textsuperscript{1346} Barnes, and Gavilán et al., respectively, reach similar findings: ‘fiscal tightening would have helped very little in attenuating the build-up of the economy’s external imbalance over this period.’\textsuperscript{1347}

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\textsuperscript{1340} Rapach and Wohar (2005). See also: Miskin (1988) ‘monetary factors are more important than budget deficits’ to the behaviour of real interest rates.’

\textsuperscript{1341} Dabrowski, 'Fiscal and Macroeconomic Governance' (2015), 16.

\textsuperscript{1342} Philip R Lane, 'External Imbalances and Fiscal Policy' (2010) IIFS Discussion Paper No 314, 1: ‘[E]ven if a \textit{prima facie} case for such a preventative mechanism can be established, it is an open question as to whether fiscal policy could be effective in performing such a role.’ See also: George Alogoskoufis, ‘Greece’s Sovereign Debt Crisis: Retrospect and Prospect’ (2012) Hellenic Observatory Papers on Greece, GreeSE Paper No 54, 4; Vanda Almeida and others, 'Fiscal Policy in a Small Euro Area Economy' (2012) Banco de Portugal Working Papers No 16 (arguing that fiscal policy can stabilise the business cycle).


\textsuperscript{1344} Lane, 'External Imbalances' (2010), 18: whatever stabilisation policy is used, the long-term fiscal position must remain sustainable if it is to be useful.


\textsuperscript{1346} Enica Detragiache, Alfonso J Hamann, 'Exchange Rate-Base Stabilization in Western Europe: Greece, Ireland, Italy and Portugal' (1997) IMF Working Paper 75.

\textsuperscript{1347} Gavilán and others (2011). Barnes (2010), 31 concludes: ‘The scope of discretionary policy aimed only at changing the overall fiscal stance is unlikely to have strong effects in many countries … it does not necessarily directly address the underlying causes of private sector imbalances.’
Testing this hypothesis, Gaspar and St. Aubyn find that starkly different fiscal policies in Spain and Portugal between 1995 and 2005 (Spain being prudent and Portugal expansionary) made no difference to their external debts.\textsuperscript{1348} The main driver is the private sector interest-rate impulse, and this remains unaffected no matter what fiscal policy is deployed against it. Lane makes a similar finding comparing the fiscal policies of Ireland and Spain against Greece and Portugal: ‘the only strong correlation is between aggregate net flows and the net flows of non-financial corporations.’\textsuperscript{1349} Other studies reach similar conclusions: The crisis happened to countries with low real interest-rates, regardless of what fiscal policy they pursued.\textsuperscript{1350} Perversely, if the underlying credit incentive is broken, attempts to diminish current account deficits by increasing the primary surplus may actually have the opposite effect due to various ‘crowding in’ effects (the space left behind by government will be filled by private capital, worsening the current account deficit).\textsuperscript{1351} Gavilán et al., for example, find that a permanent tightening of fiscal spending would lower the tax burden on the private sector and \textit{increase} domestic consumption.\textsuperscript{1352} Other studies arrive at the same conclusion: Contractions in government spending lead the private sector to increase spending.\textsuperscript{1353}

In sum, the inability of EDP fines to account for - and, if necessary, override – economic and political cost incentives at national level is profound.\textsuperscript{1354} Put simply, there is nothing EDP sanctions can do to can dampen the inexorable pull of millions of private individuals responding, in their economic and political lives, to the dysfunctional incentives of cheap credit. Nor was it ever meant to. The SGP, as originally designed, was dependent on the ‘feeding through of reputation costs to public opinion or financial markets’ to function.\textsuperscript{1355} It was never designed to stymie or replace those forces if they did not pull in the right direction. As long as the underlying incentives are broken, so also will be the EDP. Adamski explains:

‘No EU institutional measures could prevent macroeconomic imbalances from becoming unsustainable… Had peripheral countries run independent national policies, their national central banks would have countered inflation by raising interest rates, to cool down the economy and to prevent credit/investment bubbles. But this option is unavailable in the monetary union, leading to the spiral process of below-average real interest rates. Diminishing

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  \item \textsuperscript{1348} Vitor Gaspar and Miguel St Aubyn, 'Adjusting to the euro - the contrast between Portugal and Spain' (10 Years of the Euro Conference, University of Minho, Braga, Portugal, May 2009).
  \item \textsuperscript{1349} Lane, 'Capital Flows' (2013), 11.
  \item \textsuperscript{1350} Lane and McQuade (2013), 3.
  \item \textsuperscript{1351} Jacek Rostowski, 'The Approach to EU and EMU Membership: The Implication for Macroeconomic Policy in the Applicant Countries' in Marek Dabrowski, Jacek Rostowski (eds), \textit{The Eastern Enlargement of the EU} (Kluwer Academic Publishers 2001); Dabrowski, 'Fiscal and Macroeconomic Governance' (2015), 18.
  \item \textsuperscript{1352} Gavilán and others (2011), 92.
  \item \textsuperscript{1354} Feldstein (2005).
  \item \textsuperscript{1355} Commission, 'Strengthening economic governance and clarifying the implementation of the Stability and Growth Pact (Communication) COM(2004) 581 final, 8.
\end{itemize}
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real interest rates induced both the societies and the governments to drink from the poisoned chalice of overspending.1356

3.3.4 Analysis: The Failure and Abrogation of the Excessive Deficit Procedure

The economic failure of the EDP was not likely to ‘matter much’ in the end.1357 The EDP is fundamentally non-credible on its own terms.1358 By 2011, the SGP had been exceeded 97 times, and no sanctions for violation had ever been imposed. In 68 cases, sanctions should have been imposed but were not.1359 Eyraud and Wu note that ‘about half of the countries have missed the 60 percent debt ceiling more than half the time,’ and public debt for the euro area as a whole has exceeded the 60% debt limit every year since 1999.1360 Yet the machinery of the EDP is mandatory - if countries were openly flaunting the rules, the Council was expected to enforce them.1361 Irrespective of the ‘widespread failure’ of economic surveillance, the EDP has in any event ‘been ignored in virtually all its dimensions.’1362

There are two reasons for this. The first is constitutional, and well-predicted by fiscal federalism theory: As will be shown in Chapter 7, cooperative outcomes in economic policy simply ‘cannot be enforced by conventional legal techniques.’1363 Under a single currency, the only tool for dealing with mounting current account deficits is structural reform. This entails significant costs and withdrawal of privileges to be borne unequally among citizens. The Commission, for example, states that ‘the consolidation of public finances requires setting priorities and making hard choices’ and EU involvement in this process is ‘crucial.’1364 But, to put it mildly, these ‘hard choices’ are not for the Union to make.1365 They are not even for national executives to make. Decisions on public revenue and public expenditure are, in the words of the German Constitutional Court, ‘a fundamental part of the ability of a constitutional state to democratically shape itself’ and ‘the core of parliamentary

1357 Adamski, 'National Power Games' (2012), 1326.
1358 Commission Blueprint for a deep and genuine EMU COM(2012) 777 final, 2, noting ‘The SGP was insufficiently observed by the Member States and lacked robust mechanisms to ensure sustainable public finances.’
1359 In 29 cases, the deficits were excused under the exemptions in the pact: EEAG, (2011), 94.
1361 Reg 1467/97 states that the pact having a ‘sufficient deterring effect’ should ‘require’ the imposition of a non-interest-bearing deposit and ultimate fine by the Council (Rec 18, Reg 1467/97 (emphasis added)). Arts 3(4) and 7 of Regulation 1467/97 state that the Council ‘shall’ impose sanctions if its recommendations are not complied with. Lorenzo Bini Smaghi, 'What Went Wrong with the Stability and Growth Pact' in Peter Sorensen (ed), Monetary Union in Europe Essays in Honour of Niels Thygesen (DJOF Publishing 2004) 169 observes: the drafters of the SGP ‘did not intend the Treaty’s Excessive Deficit Procedure as a procedure but as a rule.’ See also: Lastra (2006), 254: The prohibition on excessive deficits was intended as a ‘firm rule’
1362 EEAG, (2011), 79.
1363 To do so would ‘disrespect the democratic legitimacy of national institutions, in particular the budgetary powers of parliaments.’ Joerges (2013).
1365 Amtenbrink and De Haan, 'Reforming the stability and growth pact' (2006), 404.

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rights in democracy.' The EDP simply cannot compel Member States to defy markets and electorates when those forces state that they should do otherwise. As Adamski observes:

‘Member States are still largely sovereign when it comes to structurally important economic policies. Voters in individual countries ultimately determine their trajectories. No gimmicks, no shortcuts, no one-size-fits-all golden rules can reshape this foundation. […] Whether or not it is happy with this situation, the democratically unaccountable Commission must accept this political constraint in the European political constitution of economic governance.’

The second is institutional, and arises from the first: The SGP suffers from a serious time-inconsistency problem. Ex-post enforcement requires finance ministers, accountable to their own electorates and markets, to apply sanctions to the actions of other finance ministers, accountable only to their electorates and markets. From the outset, this ‘sinners judging sinners’ problem of ex-post enforcement was widely seen as fatal to a sanctioning mechanism which is reliant on ex-ante deterrence. For example, in 1994, the German Federal Diet declared that it would oppose any political initiative to ‘relax’ the Maastricht criteria, yet by 2003 Germany itself was in defiant breach of the rules. In 2002, the Council eschewed Commission recommendations to issue warnings to Germany and Portugal, refraining from even putting the recommendation to a vote. In 2004, Greece was placed under budgetary surveillance by the Commission and the Council, but sanctions were never applied, despite the IMF’s finding that ‘data shortcomings are a recurring problem in Greece.’ Instead, surveillance was lifted in 2007 – a little over a year before Greece issued its revised deficit forecast of 12.7%. If the EDP had worked, the entire ‘sovereign debt’ character of the crisis might have been avoided. Yet the Commission ‘for various political and methodological reasons’ failed to enforce infringement proceedings, such that ‘the system was not even able to name

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1366 Aid Measures for Greece (Germany) [122].
1367 Adamski, ‘Misguided Constitution’ (2013), 58 ‘Irrespective of the academic discussions on the Union’s democratic deficit, the organization can pursue structural reforms only when and where they are backed by… democratic support.’
1369 Morris, Ongen and Schuknecht (2006).
1370 Groetke and Mause (2012), 287. Amtenbrink and De Haan, ‘Fiscal Policy Discipline versus Flexibility’ (2003), 1095 (the same ministers, who are responsible for drafting national budgets, also have to decide whether they breach the 3 per cent criterion and the medium term objective’); Herdegen (1998), 31 (observing the ‘reluctance of (most) member States to tie their hands in the application of a mechanism that might lash out against themselves’); Allard and others (2013) 11 (‘when left to the Council - which is imposed of national Ministers - the temptation remains to under-enforce fiscal rules and delay adjustment’); Lastra (2006), 269: ‘if the sanctions or penalties foreseen in the excessive deficit procedure when the budgetary rules are breached are not applied, the ‘deterrent effect’ of the SGP disappears, ‘inviting’ other Member States to be ‘fiscal delinquents’ too). See also: Damian Chalmers, ‘The European Redistributive State and a European Law of Struggle’ (2012) 18 ELJ 667, 692.
1371 See: Herdegen (1998), 27
1372 European Council, Conclusions of 12 February (2002) EUCO 6108/02, 9, 22.
1373 IMF, Staff Report for the 2009 Art IV Consultation (Greece) (IMF, 2009), 20-21.
1374 The 12.7% figure was subsequently revised upwards to 15.4% of GDP. The Greek revelations roughly coincided with the November 2009 request by Dubai World for a six-month debt moratorium which shock financial markets and led to a global reassessment of sovereign risk exposures. See: Gibson, Hall and Tavlas (2012), 504.
and blame the country that was particularly dishonest about the real extent of its budgetary problems. Rodden agrees: The European [EDP] proved to be unenforceable… Those half-hearted efforts at hierarchical regulation inadvertently undermined market discipline by sending significant signals about the central government’s lack of credibility. … Weak or half-hearted regulation may have been worse than no regulation at all.’

The evisceration of the EDP was completed in 2003, when excessive deficit procedures were initiated against France and Germany and, rather than abide the rules, they openly flaunted them. In the 2003 EDP on France and Germany, the Commission found that France ‘did not take measures’ required to correct its excessive deficit, and that the targets had been similarly ‘abandoned’ by Germany. It recommended that the Council declare ‘no effective action’ and issue notice (the final step before sanctions). Instead, under political capture from France and Germany, the Council issued ‘Conclusions’ in which it professed to put the procedures in abeyance. When challenged by the Commission before the Court of Justice in Commission v Council, the court confirmed the political character of the EDP: a refusal to adopt the Commission recommendations was not an act which was capable of giving rise to legal challenge. The EDP could be lawfully held in abeyance whenever the Commission failed to achieve the required majority.

1376 Adamski, 'National Power Games' (2012), 1337, noting ‘Hollow enforcement is always conducive to moral hazard.’ As the Commission itself notes, the Greek situation was ‘made possible by the shortcomings of the existing economic surveillance framework.’ Commission, ‘Reinforcing economic policy coordination’ COM(2010) 250 final, 4.
1377 Rodden (2014), 45.
1378 In January 2003, Germany’s 2002 deficit (3.7% of GDP) and debt (60.9% of GDP) both exceeded the respective reference values in the Treaty, with forecasts to a deficit of 3.8%. The recommendation to Germany asked it to take steps to correct the deficit ‘as rapidly as possible’ (i.e. within four months). France’s deficit forecasts (3.1% of GDP rising to 3.7% of GDP) and gross debt forecasts (59% of GDP rising to 61.8% of GDP) both exceeded the limits of the SGP. The recommendation was to resolve the situation by the end of 2004: Commission Recommendation for a Council Recommendation to France with a view to bringing an end to the situation of an excessive government deficit SEC (2003) 516 final; Council Decision 2003/487/EC of 3 June 2003 on the existence of an excessive deficit in France [2003] OJ L 165/9; Council Recommendation of 21 January 2003 with a view to bringing an end to the situation of an excessive deficit in Germany SEC(2003) 5540/03; Council Decision 2003/89/EC of 21 January 2003 on the existence of an excessive deficit in Germany [2003] OJ L 34/16.
1381 ECOFIN Council Conclusions of 25 November 2003 14492/1/03 REV 1 (en) (Presse 320) 15-19. This appeared to violate the express wording of the SGP that the EDP cannot be put into abeyance until effective action has been taken: Arts 4, 9, Reg 1467/97.
1382 Though the ECJ annulled the ‘Conclusions’ on the basis that the Council had not followed the procedures set out in the Treaty. The Council could not supplant the Commission’s power of initiative by replacing a ‘procedure’ with a political ‘conclusion’ in the absence of a Commission recommendation, nor could it negotiate individual criteria with the Member State in the stead of relying upon the criteria set out in the recommendation: Case C-27/04 Commission v Council, [34].
1383 Case C-27/04 Commission v Council [81]-[86]
It must be emphasised that this institutional vulnerability remains in spite of any subsequent reform of the SGP.\textsuperscript{1384} As Gross et al point out, the French and German rebellion concerned the application of Articles 126(8) and (9) TFEU - not the secondary-law SGP.\textsuperscript{1385} The Treaty called for the enforcement of the debt and deficit reference values, and this was not done. As the ECB warned in a press release responding to the Franco-German rebellion, this is an irreparable credibility failure.\textsuperscript{1386}

In the aftermath of the Franco-German rebellion, the SGP was amended in 2005.\textsuperscript{1387} The changes did not strengthen enforcement provisions, nor did it introduce any institutional changes to insulate the pact against political capture.\textsuperscript{1388} Instead, it made a number of changes which loosened the application of the rules:

Under the MSP, the deficit requirement of ‘close to balance or in surplus’ (0.5\% of GDP) was replaced with differentiated medium-term objectives (MTOs) of up to -1\% of GDP;\textsuperscript{1389} discounts were provided for anticipated structural reforms;\textsuperscript{1390} and the obligation to achieve ‘sustained convergence’ was replaced an obligation to achieve the MTO over the cycle.\textsuperscript{1391}

Under the EDP, the -2\% of GDP trigger for an ‘exceptional and temporary’ escape clause was replaced with a ‘negative annual GDP volume’ and/or an ‘accumulated loss of output during a protracted period of very low annual GDP volume growth relative to its potential’ (effectively widening the exception to any downturn),\textsuperscript{1392} and a litany of ‘other relevant factors’ was added before an excessive deficit could be found.\textsuperscript{1393} For the enforcement of the pact, the deadlines for taking effective action and imposing sanctions were both extended by double;\textsuperscript{1394} the

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\item \textsuperscript{1384} Adamski, 'National Power Games' (2012), 1323; Helge Berger, Jakob De Hann, David-Jan Jansen, 'Why has the Stability and Growth Pact Failed?' (2004) 7 Int Financ 235, 236; Lastra (2006), 269-272
\item \textsuperscript{1388} For discussion: Deroose and Langedijk (2004); Morris, Ongena and Schuknecht (2006), 5; Amtenbrink and De Haan, 'Reforming the stability and growth pact' (2006).
\item \textsuperscript{1389} Arts 1(1), 2a Reg 1055/2005.
\item \textsuperscript{1390} Art 2a, Reg 1055/2005, amending Art 5(1) Reg 1466/97. This is one of the ‘most visible’ weaknesses of the 2005 reform: Lastra (2006), 262.
\item \textsuperscript{1391} I.e. a benchmark of 0.5\% of GDP in cyclically adjusted terms, net of one-off and temporary measures: Art 2a(3), 2a(5) Reg 1055/2005, amending Art 5(1), 9(1) Reg 1466/97.
\item \textsuperscript{1392} Art 1(1) Reg 1056/2005, amending Art 2 Reg 1467/97.
\item \textsuperscript{1393} These are: Potential growth, cyclical conditions, fiscal consolidation in good times, public investment, the quality of public finances, the implementation of Lisbon Agenda objectives, pension reform and research and development policies, as well as ‘any other factors’ which the Member State concerned holds relevant. In particular, ‘Special consideration’ would be given to financial contributions to European policy goals, raising the prospect of Member States receiving a discount for spending on EU priorities, where to spend on their own would be prohibited. Art 1(1), Reg 1056/2005, amending Art 2 Reg 1467/07.
\item \textsuperscript{1394} Arts 1(2), 1(3) Reg 1056/2005, amending Art 3, 5, Reg 1467/97.
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requirement for correction within a year was amended to a consolidation of 0.5% of GDP; and new 1-year extension for ‘unexpected adverse economic events’ was introduced, where the Council was previously supposed to decide to grant notice. These escape clauses would have all applied to the German and French situation in 2003.

In first year of the new rules, a mere four of twelve EMU Member States complied with their MTOs, and no country under an EDP expressed an intention to meet their MTO’s until the following decade. In 2005, Germany violated its EDP recommendations and, instead of sanctions, the Council granted Germany a two-year extension despite the reformed EDP only introducing extensions by up to one year. The regime again failed to apply on its own terms.

Instead of increased attention to macro-fiscal linkages, the SGP was suddenly just compatible with a wider range of outcomes. For a country with a 70% debt-to-GDP, the EDP was compatible with any result from a return to balance to a deterioration of 10pps within a decade. Scenarios for Greek debt within the boundaries of the rules ranged comfortably between 70% and 130% of GDP by 2015. As Feldstein quips: ‘Exactly how this is all to be reconciled with an unambiguous treaty obligation is not clear.’ In 2005, the Financial Times observed:

‘[I]t is becoming increasingly clear that the markets will have to provide the Eurozone with the financial discipline that governments seem unable to muster. The Eurozone’s original straitjacket, the grown and stability pact, has been made more flexible, but five of the 12 member governments are still in breach of it.’

3.4 Conclusions: Economic Criteria for EU Federalism

This chapter examines the macroeconomic antecedents of the failure of the Maastricht architecture and concludes that nominal interest rate convergence - not sovereign debt - is the causa sine qua non for the crisis. The model did not fail because investors failed to appropriately price risk, and it did not fail because of sovereign debt. The model failed because markets (correctly) assessed that the ‘no

1395 Arts 1(2), 1(3) Reg 1056/2005, amending Arts 3m 5 Reg 1467/97. While the default deadline for correction remains a year, provision is made for special circumstances granting an extension, which assessment includes the ‘other relevant factors’ suggested by the Member State.

1396 Arts 1(2), 1(3) Reg 1056/2005, amending Art 3, 5, Reg 1467/97.

1397 These were: Spain, Ireland, the Netherlands, and Finland. Morris, Ongena and Schuknecht (2006), 27.

1398 Morris, Ongena and Schuknecht (2006), 36. A similar episode occurred when Italy and Portugal became subject to excessive deficits in 2005, but were given extensions on the basis of ‘special circumstances’ on the basis of low growth scenarios in both countries: Council Decision 2005/694/EC of 28 July 2005 on the existence of an excessive deficit in Italy [2005] OJ L 266/57

1400 Morris, Ongena and Schuknecht (2006), 31 (the SGP had ‘been adjusted to accommodate existing policies rather than the other way around); EEAG, (2011) 79 (‘Whatever remains of the Pact, it is generally considered to be toothless...’); and Editorial, 'The Ticking Euro Bomb: How the Euro Zone Ignored its Own Rules' Spiegel (6 October 2011) <http://www.spiegel.de/international/europe/the-ticking-euro-bomb.html> accessed 24 July 2015: ‘Its provisions were not formally abolished, but... they could be twisted at any time.’

1401 Morris, Ongena and Schuknecht (2006), 24-25


1403 Feldstein (2005), 424.

1404 Editorial, 'ECB shows its hand’ (2005).
bailout’ rule was non-credible, and (correctly) guessed that the EU would sooner re-write the Treaties than allow a Member State to default. The failure of the Maastricht model is a failure of EU institutions and EU law.

The operational hypothesis of this chapter, that individual exposure to market discipline is an indispensable requirement for European fiscal federalism, is shown to be robust at each stage of the analysis. While the macroeconomic consequences manifest differently in each of the five crisis-hit Periphery countries, the common denominator is the same: The disconnection of credit prices from economic fundamentals prevailing at national level caused by the failure of Articles 121-126 TFEU to induce markets to apply differentiated credit-risk to sovereign debt. The chain of causality traced in this chapter is not capable of running in reverse (from fiscal policy to net external indebtedness or credit expansion), and there are no common public debt factors which separate ‘Core’ from ‘Periphery’ groups. Whatever other economic characteristics divide the Member States, the single price of credit remains the ‘common factor behind the evolution of their situations.’

The chain of causality traced from this condition runs through each pillar of the Maastricht architecture:

[3.1] The *causa sine qua non* of the breakdown of the Maastricht architecture is a severe mispricing of public debt under market bailout expectations. As the *Bundesbank* President concludes, ‘this expectation put downward pressure on risk premiums on government bonds, thus distorting the pricing system; and we all know what happened next.’

[3.1.2] Nominal interest-rate convergence resulted in a ‘severe mispricing of risk of both private and public assets’ according to keystone indicators of macroeconomic risk;

[3.1.3] Below-Taylor rule interest-rates precipitated the damaging feedback cycle predicted by the ‘Walters Critique;’ and

[3.1.4] Private sector domestic credit expanded to 232% of GDP in Ireland, 212% of GDP in Spain, 187% in Portugal, 94.28% in Greece, and 66% of GDP in Italy by 2009.

[3.1.5] Low and negative real interest-rates under the single nominal rate – not sovereign debt – is the denominator that binds Periphery countries to the chain of causality pursued in this chapter and distinguishes them from the Core.

[3.2] The Multilateral Surveillance Procedure failed to prevent (or even detect) historically unprecedented macroeconomic imbalances due to a breakdown in the cost-levying function of credit (at national level) and severe information asymmetries (at EU level).

[3.2.1] Massive amounts of capital (particularly gross debt) entered Periphery economies with no liquidity or exchange-risk premium, effectively exceeding the capacity of their host states to finance them. EMU-12 claims on Periphery banks exceeded 249% of GDP in Ireland, 50% of GDP in Spain and Italy, 58% in Greece, and 90% in Portugal.

[3.2.2] Interest-rate convergence fuelled current account imbalances which are unprecedented in thirty years of post-WWII economic data.

[3.2.3] In an environment of

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1406 Weidmann 'Crisis management and regulatory policy' (2013).
unresponsive credit prices, EU institutions suffer from serious information asymmetries that prevent them from perceiving, and then responding to, information about the character of interest-rate adjustment at local level.

[3.3] The failure of the EDP is both institutional and fundamental. Institutional, because the EU’s fiscal rules suffer from endemic credibility failure. Fundamental, because so long as the European Union wishes to remain a democracy, supranational policy imperatives (whether exerted by peer pressure, fines or law) are simply incapable of overriding the macroeconomic and political imperatives of millions private individuals responding, in their economic and political lives, to dysfunctional cost incentives. Compliance with the SGP does not change the pattern of causality traced in this chapter because general government debt is not a significant predictive indicator of the sovereign debt crisis - real interest rates and private-sector credit are. [3.3.1] The EDP is irrelevant, if not an aggravating factor, to the cascade of economic indicators in this chapter.\[1408\] [3.3.2] The spike in bond yields that make up the ‘sovereign debt crisis,’ properly so-called, is but the final symptom of a deeply-rooted imbalance caused by the disconnection of credit from underlying economic conditions. [3.3.3] Causality is incapable of running in reverse: Real interest rates are, in fact, ‘a monetary phenomenon’ - not a fiscal one, and no optimal fiscal policy is shown to be capable of causing - or preventing - the crisis.\[1409\]

This conclusion challenges the incumbent prescription for European fiscal federalism. The ‘fatal flaw’ at the heart of the Euro is not sovereign debt, it is not caused by governance failure, and it not due to the inability of the central authority to control the public finances of its Member States. The fundamental failure of European fiscal federalism is the archetypal pathology of fiscal federalism theory against which the entire Maastricht architecture was drafted against – soft budget constraints under a (now realised) bailout expectation. As Stark so puts it:

‘Historical examples show that the aforementioned principles and rules are essential for the smooth functioning of a monetary union. […] The allegation that the Maastricht blueprint is flawed is incorrect. What is correct is that the Maastricht concept was never fully implemented… The constituent principles of economic and monetary union were not only interpreted loosely, they were disregarded.’\[1410\]

\[1408\] In all five countries, the imbalances occurred entirely (Ireland and Spain), overwhelmingly (Portugal and Greece), or equally (Italy) in the private sector. It is true that ‘public debt was not sufficiently reduced’ in two countries (Greece and Italy), but in no country can it be said that the sovereign debt crisis would have emerged without these effects of interest rate adjustment. See: Pisani-Ferry (2011); Pisani-Ferry, ‘Streetlamp syndrome’ (2011).

\[1409\] Rapach and Wohar (2005).

\[1410\] Stark (2013), 544-545 (sentences reversed).
4. Constitutional Criteria for EU Fiscal Federalism

By advancing through the three preceding analyses, Part I of this study yields two testable constitutional criteria to comply with the legal boundaries identified in Chapter I of this thesis:

First, any model of European fiscal federalism must preserve the fiscal sovereignty of the twenty-eight constitutional democracies which form the basis of its legal order. In so far as the Union is founded upon the principles of conferral, it can have no powers other than what the Member States have given it, and *nemo plus iuris transfere (ad alium) potest quam ipse habet*, what the Member States have given it is limited by their own constitutional identities. The operational hypothesis in that regard is that any machineries of public economics which trespass on the tests for democratic legitimation under Member State ‘constitutional identity’ and ‘ultra vires’ review jurisdictions will not take effect in the legal system, and will not be compatible with the European legal order, *de lege lata* or *de lege ferenda*. Fiscal sovereignty is a permanent constitutional constraint upon the application of fiscal federalism theory in the European Union.

Second, hard budget constraints and individual exposure to market discipline are indispensable requirements for the fundamental guiding principles of price stability, sound public finances, and a sustainable balance of payments. According to the BVerfGE, the fundamental principles of the *Stabilitätsgemeinshaft* are ‘the basis and subject-matter of the German Act of Accession.’ In particular, the BVerfGE has held that the ‘no bailout rule’ and ‘no monetary financing rules’ safeguard the Bundestag’s ‘national budgetary responsibility,’ and Germany’s constitutional identity would be violated if the *Stabilitätsgemeinshaft* became a ‘liability community’ through the ‘direct or indirect communitarisation of state debts.’ The hypothesis in that regard is that systems of fiscal federalism theory which substitute hard budget constraints for centralised legal governance are not compatible with the guiding principles of price stability and fiscal discipline, and are not compatible with the European legal order.

These criteria will be tested and applied against positivist empirical methodologies in the second half of this thesis. Here, they are extracted here from three constituent analyses, as follows:

[1] Two constitutional boundaries of the European legal order condition and constrain fiscal federalism in the European Union. The first is fiscal sovereignty. Not only has economic policy not

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1411 See, for statements to that effect: Germany: Re Lisbon (Germany) [221]. Denmark: Carlsen (Denmark) [13]. Poland: ESM & TSCG (Poland) [6.3.1]. Ireland: SPUC v Grogan I (Irish Supreme Court), 769, per Walsh J.
1412 Brunner (Germany) [80]-[89]. See also: Aid Measures for Greece (Germany) [129]; Re ESM I (Germany) [203]; Gauweiler I (Germany) [32]. This encompasses, specifically, the independence of the ECB (Art 130 TFEU) the prohibition on monetary financing (123 TFEU) the no-bailout clause (125 TFEU) and the stability criteria of the SGP: Brunner (Germany) [89], [204]-[205]; Aid Measures for Greece (Germany) [181]-[182]. Re ESM I (Germany) [203]-[204].
1413 Re ESM I (Germany) [203]; Re ESM II (Germany) [167]-[171]; Aid Measures for Greece (Germany) [129], [137]; Gauweiler I (Germany) [41].
been conferred on the Union, it cannot ever be so conferred without abrogating, *inter alia*, the Democratic State (Article 20 BL) shielded by the ‘eternity clause’ (Article 79(3)) of the German Basic Law.\textsuperscript{1414} Numerous other constitutional courts have drawn similar boundaries around fiscal sovereignty.\textsuperscript{1415} The second is the fundamental guiding principles of price stability and fiscal discipline binding on the constitutional authorisation for EMU under Article 119 TFEU. These principles are a constitutional stipulation of the EU’s conferred competence in economic coordination and monetary policy *lex lata*, and are in turn constrained by other principles, such as fiscal sovereignty, which are not amendable *lex ferenda*.\textsuperscript{1416}

[2] The architecture of European fiscal federalism in Chapter 1, ‘Economic Policy’ of Title VIII TFEU enshrines a constitutional consensus on fiscal sovereignty and market discipline as indispensable requirements for the achievement of EMU. According to the *travaux préparatoires* of the CoG, the Monetary Committee and ECOFIN, financial assistance and centralized fiscal governance are incompatible with the mandate of price stability and fiscal discipline as a matter of both law and economics.\textsuperscript{1417}

[3] Contrary to the dominant narrative of the crisis, the economic pathology at the heart of the EMU is not sovereign debt; it is not caused by governance failure; and it not due to the inability of the Union to override economic choices of its Member States. The *causa sine qua non* of the European sovereign debt crisis is the archetypal pathology of federalism against which the entire Maastricht architecture was drafted against: soft budget constraints and a failure of market discipline under a (now realised) bailout expectation. Bini Smaghi summarises the three failed assumptions of Maastricht as follows:

‘The first was that markets would exert strong pressure on euro area fiscal policies. The second assumption was that if the first assumption were insufficient to discipline public finances, then the Stability and Growth Pact, based on monitoring, peer pressure and sanctions, would do the job. The third assumption, reinforcing the previous ones, is that if a member of the euro area were unable to implement sound fiscal policies, it would be left to its own devices.’\textsuperscript{1418}

\textsuperscript{1414} *Aid Measures for Greece (Germany)* [107], [127]; *Brunner (Germany)* [91]; *Re Lisbon (Germany)* [228], [232]; *Re ESM I (Germany)* [193], [196]; *Re ESM II (Germany)* [161]-[165]; *Gauweiler I (Germany)* [28]; *Gauweiler III (Germany).*

\textsuperscript{1415} France: *Maastricht I (France)* [43]; *Maastricht II (France)* [31]-[35]; *TSCG (France)* [16]; Ireland: *Crotty (Ireland), 783*; *Pringle I (Ireland)* [8.14]; *Collins (Ireland)* [95]-[98]. Poland: *Lisbon (Poland)*, 200; *ESM & TSCG (Poland)*; Estonia: *ESM (Estonia)* [105], [106], [144]. Czech Republic: *Lisbon I (Czech Republic)* [91], [93]. Spain: Catalonia DTC 134/2011 (Spain) [8](a). Austria: *ESM (Austria)* [104]-[105]. Finland: *Opinion on the Six Pack I-III (Finland).*

\textsuperscript{1416} *Brunner (Germany)* [80]-[89]; *Aid Measures for Greece (Germany)* [129]; *Re ESM I (Germany)* [203]; *Gauweiler I (Germany)* [32].


Part II
5. The Emergent Model of European Fiscal Federalism
5. The New Model

In the wake of the economic cascade and collapse of the Maastricht model, European fiscal federalism is increasingly the subject of piecemeal renegotiation that exceeds the limits of the Treaty model.1419 The remainder of this thesis will apply the criteria extracted from Part I in order evaluate the emerging model of European ‘fiscal union’ and identify a model of fiscal governance that is both theoretically and empirically compatible with the European legal order. The purpose of this chapter is to embark on this process by identifying the emergent federal model from the perspective of fiscal federalism theory and establishing its demands on the European legal order. Section 5.1 begins by providing a brief overview of the amendments to the federal architecture since the crisis. Section 5.2 then examines its constituent machineries and classifies the new model from the perspective of fiscal federalism theory. Section 5.3 concludes by examining the demands placed on the European legal order to provide directions for the duration of this study.

The model identified in this chapter forms a nascent proto-fiscal union comprised of four pillars:

[1] Conditional financial assistance, which principal architecture is now comprised mainly of the European Stability Mechanism and Article 136(3) TFEU;

[2] Centralised governance of budgetary frameworks, which architecture is comprised of the European Semester and a web of secondary law interlinkages with Member State budgetary frameworks under (primarily) Directive 2011/85/EU and Reg 473/2013;

[3] Centralised fiscal governance, which architecture is comprised principally of the Multilateral Surveillance Procedure, the Excessive Deficit Procedure, and the (intergovernmental) Treaty on Stability, Coordination and Governance; and


The demands placed on the European legal order by these reforms are significant. The emergent federal architecture supplants a legal pillar of fiscal sovereignty (an entrenched ‘no-bailout’ law) for a legal feature of unitary states (centralised economic and fiscal governance).1420 The constitutional boundaries underlying this architecture, however, have not changed. As the Bundesbank states, ‘the


1420 See: the main pillars of reform launched by the Task Force report established by the March 2010 European Council: Strengthening Economic Governance in the EU: Report of the Task Force to the European council (21 October 2010) 6. See also: Craig, ‘Pringle’ (2013); Koen Lenaerts, ‘EMU and the EU’s constitutional framework’ (2014) 39 EL Rev 753; Merino (2012); Kelemen and Teo (2012), 4. Some scholars have suggested that the significant overlap between rules-based and coordination-based economic governance have produced a ‘hybrid’ governance structure which is not easily divisible into normative methods of governance or ‘pillars.’ See: Armstrong (2013); Besselink and Reestman (2012), 7 (referring to a new ‘composite’ constitutional order of Europe); Edoardo Chiti and Gustavo Teixeira (2013).
no bail-out principle, member states’ national responsibility for their own fiscal policy as well as investors’ individual responsibility for their investment decisions remains constitutional components of monetary union.\textsuperscript{1421} This raises two constitutional issues for the European legal order.

First, as a matter of fiscal federalism theory, conditional financial assistance and centralised debt brakes are tenets of (centralised) fiscal union which appear inapposite to the stabilitätsgemeinschaft which binds the mandate for EMU under Article 119 TFEU and forms the basis of the German Act of Accession under Article 23 BL. The hypothesis of this thesis is that any machineries of public economics which trespass on the specific tests for democratic legitimation under Member State ‘constitutional identity’ and ‘ultra vires’ review jurisdictions will not take effect in the legal system, and will not be compatible with the European legal order, \textit{de lege lata or de lege ferenda}.

Second, in order to stabilise the new model and safeguard the price stability monetary union, European economic governance has been broadened to virtually all areas of fiscal, economic and social policy, and imbued with strictures of increasingly precise and binding force.\textsuperscript{1422} EU-legislated norms increasingly prescribe - in great detail and on pain of punitive sanctions or direct legal enforcement - substantive policy choices which are ordinarily the legislative competence of Europe’s constitutional democracies. If the model is to ‘work,’ it is dependent upon the constitutionality of its constituent mechanisms under Member State ‘constitutional identity’ and ‘ultra vires’ jurisdictions. The hypothesis of this thesis is that hard budget constraints and market discipline are indispensable requirements for the fundamental guiding principles of price stability and fiscal discipline in a European legal order bound, as it is, by the fiscal sovereignty of its 28 constitutional democracies. Accordingly, systems of fiscal federalism which substitute hard budget constraints for centralised legal governance are not compatible with the guiding principles of price stability and fiscal discipline, and are not compatible with the constitutional boundaries of EMU.

\subsection*{5.1 Overview of Reforms}

The reformulation of the Treaty model began on 2 May 2010, with the announcement of a €110bn package of bilateral loans to Greece.\textsuperscript{1423} This was followed the same year by the creation of the European Financial Stabilisation Mechanism (the EFSM), a €60bn bailout mechanism founded under EU law,\textsuperscript{1424} and the European Financial Stability Facility (the EFSF), a special purpose vehicle


founded by the EMU Member States with a €440bn lending capacity. In 2012, these mechanisms were eclipsed by the European Stability Mechanism (ESM), a €705bn intergovernmental organisation subscribed by the 19 Euro Member States with a €500bn lending capacity.

In order to stabilise the new model and safeguard the price stability monetary union, the counterpart to the communitarisation of risk has been the introduction of binding constraints on national macroeconomic policies, a significant deepening of constraints on fiscal policies, and an unprecedented extension of the EU’s economic governance procedures into national budgetary processes. Reforms began with the adoption of an overarching package of legislation known as the ‘six pack’ in 2011. The six pack consists of three regulations expanding the scope and intensity of the SGP; two regulations introducing a new ‘Macroeconomic Imbalance Procedure’ extending EU governance into the realm of (previously excluded) macroeconomic policy, and a directive which set out binding requirements for national budgetary framework. This was followed by the ‘two pack’ legislation in May 2013. This consists of Regulation 472/2013, introducing a fortified governance regime to enforce financial assistance programmes, and Regulation 473/2013, introducing new requirements for national budgetary procedures (including provisions pertaining to the content of Member State budgets).

In March 2012, this framework was supplemented by the Treaty on Stability Coordination and Governance (the ‘TSCG’), an intergovernmental treaty that is formed outside the EU treaties under public international law, but which is nonetheless interlaced with secondary EU law. The

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1425 EFSF Framework Agreement; EFSF Articles of Association.
1426 The signatories to the TESM are Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovenia, Slovakia, Spain, Latvia, Lithuania.
1427 Deutsche Bundesbank (2011) 11 (centralised fiscal governance is the quid pro quo for the communitarisation of risk).
1428 The purpose of the six pack is to restore ‘confidence in the quality of the policy and decision making process’ and to give ‘earlier warning of where national situations are going off track.’ Commission, ‘Enhancing economic policy coordination’ COM(2010) 367 final; Commission, ‘Reinforcing economic policy coordination’ COM(2010) 250 final, 3.
1434 Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG) Between the Kingdom of Belgium, the Federal Republic of Germany, the Republic of Estonia, Ireland, the Hellenic Republic, the
centrepiece of the TSCG is the ‘Fiscal Compact’, a justiciable obligation on Member States to institute a ‘balanced budget rule’ in national law of constitutional or permanent character, or otherwise guaranteed to be respected throughout the budgetary process.  

Until 2012, amendments to the federal model appeared as merely incidental to ad-hoc and piecemeal responses to the crisis, with apparently only belated consideration of whether these elements would amount to a coherent, unitary economic model, and whether that model might adhere to the Treaties. Bilateral loans to Greece, for example, took place outside the Treaties, with conditionality inscribed in secondary EU law, with no justification of legality. In other cases, crisis measures outpaced committees assigned to give them sober legal aforesaid. The question of EFSM/EFSF financial assistance, for example, was assigned to a task force in March 2010, only to have both the EFSF and EFSM come into existence before the task force could submit its report in October 2010. It ultimately failed to conclude that financial assistance was reconcilable with the existing treaties. By that time, a combined €198bn in bailouts had been issued under three separate legal instruments. The EFSM was later to be tacitly recognised by both the European Council and the ECJ as wanting a proper legal basis, and in December 2010 ‘a limited treaty change’ was agreed to replace them with the ESM – only to have the ESM enter into force before the amendment thought necessary to provide it sufficient legal cover.

Kingdom of Spain, the French Republic, the Italian republic, the Republic of Cyprus, the Republic of Latvia, the Republic of Lithuania, the Grand Duchy of Luxembourg, Hungary, Malta, the Kingdom of the Netherlands, the Republic of Austria, the Republic of Poland, the Portuguese Republic, Romania, the Republic of Slovenia, the Slovak Republic, the Republic of Finland and the Kingdom of Sweden (2 March 2012, Brussels). The TSCG entered into force on 1 January 2013 for 16 Member States, and was ratified by all remaining signatories by 1 April 2014. TSCG. European Council, ‘1-2 March 2012 Conclusions’ (Brussels, 8 May 2012) EU CO 4/3/12 Rev 3.


Merino (2012), 1614: the measures followed an incremental ‘law of evolution’ rather than any ‘preconceived plan.’

Recourse to Article 122(2) TFEU could not be had, since the loans came from the Member States. The only justifications tangentially related to legality were a Commission statement referencing the ‘exceptional crisis for which the euro area was left with no remedial instrument’, Commission, ‘Reinforcing economic policy coordination’ COM(2010) 250 final, 10, and the Eurogroup (2 May 2010) statement that ‘loans will be granted on non-concessional interest rates.’ See also: Statement by the Heads of State or Government (Brussels 25 March 2010); European Council, Statement by the Heads of State or Government in the European Union (Brussels 11 February 2010).


The Task force on Economic Governance Strengthening Economic Governance (21 October 2010) concluded: ‘The setting up of a crisis resolution framework requires further work. As it may imply a need for Treaty changes, depending on its specific features, it is an issue for the European Council.’

European Council Conclusions of 16-17 December 2010; Council Decision 2011/199/EU rec 4; Pringle v Ireland [116].

European Council Conclusions of 16-17 December 2010, para 1; European Council Conclusions of 28-29 October 2010 (Brussels, 20 November 2010) EU CO 25/1/10 Rev 1, para 2. The impetus for this reform followed on from a meeting between French President Sarkozy and German Chancellor Angela Merkel on 18 October at the French resort Deauville: Statement for the France-Germany-Russia Summit (Deauville 18 October 2010).
The fiscal architecture is now embedded in a bewildering and inchoate constellation of over twenty separate legal instruments in various legal forms, both within and without the framework of the Treaties, which both cross-amend and interlace with each other.\footnote{For a coherent summary, see: Alexandre De Streele, 'The Evolution of the EU Economic Governance since the Treaty of Maastricht: An Unfinished Task' (2013) 20 MJ 336. On the normative consequences of this array, see: Armstrong (2013); Edoardo Chiti and Gustavo Teixeira (2013), in particular at 692.}

It should be emphasised at the outset that the architecture set out here and picked-apart for the duration of this study is as-yet inchoate. In June 2012, the ‘Four Presidents report’ envisioned ‘a fully-fledged fiscal union’ entailing, inter alia, a power to rewrite Member State budgets, mutualised debt, and the ‘joint exercise of sovereignty.’\footnote{Van Rompuy, (2012). This was accompanied by an equivalent report issued by the European Parliament in October: European Parliament, Report with recommendations to the Commission on the report "Towards a genuine Economic and Monetary Union" (A7-0339 - 2012/2151(INI), 2012). At its June and October 2012 meetings, the European Council invited the President to build on the EU’s existing institutional and legal framework: European Council Conclusions of 28-29 June (2012) EUCO 76/12; European Council Conclusions of 18-19 October 2012, para 5. For a discussion of the legal stages of the report, see Alan Dashwood, 'The United Kingdom in a re-formed Union' (2013) 38 EL Rev 737.} This was followed by the Commission’s ‘Blueprint for a deep and genuine economic and monetary union’ which called for a ‘full banking union,’ a ‘full fiscal union,’ a ‘full economic union’ and a ‘full political union.’ The completed union would:

‘involve a political union with adequate pooling of sovereignty with a central budget as its own fiscal capacity and a means of imposing budgetary and economic decisions on its members...’\footnote{Commission Blueprint for a deep and genuine EMU COM(2012) 777 final (emphasis added) (arguing that the power to re-write national budgets under the co-decision procedure would be justified in terms of democratic legitimacy, since Member State legislatures would still be adopted (presumably once amended by the EU) by the national parliament).}

In 2015 the Five Presidents’ Report concretised these proposals into a multi-stage plan to use EU mechanisms ‘forcefully’ and centralise Member State fiscal policy under ‘binding … EU legislation, as sovereignty over policies of common concern would be shared and strong decision-making at euro area level would be stablished.’\footnote{Jucker and others, Five Presidents Report (2015), 9. In December 2012, the European Council endorsed a ‘Roadmap’ for the completion of EMU. It noted the Van Rompuy Report, but refrained from endorsement of ex-ante binding control of economic policy. European Council Conclusions of 13-14 December.}

The legal landscape remains unchanged as of the time of submission, though Commission meeting minutes shows that a ‘new phase’ has begun.\footnote{European Commission, Minutes of the 2111th meeting of the Commission held in Strasbourg (Winston Churchill) on Tuesday 13 January 2015 PV(2015) 2111 final; European Commission, Minutes of the 2117th meeting of the Commission held in Brussels (Berlaymont) on Wednesday February 2015 PV(2015) 2117 final; European Commission, Minutes of the 2143rd meeting of the Commission held in Brussels (Berlaymont) on 21 October 2015 PV(2015) 2143 final; European Commission, Minutes of the 2126th meeting of the Commission held in Brussels (Berlaymont) on Wednesday 15 May 2015 PV(2015)2126 final; European Commission, Minutes of the 2155th meeting of the Commission held in Brussels (Berlaymont) on Friday 5 February 2016 PV(2016) 2155 final; European Commission, Minutes of the 2158th meeting of the Commission held in Brussels (Berlaymont) on 24 October 2016 PV(2016) 2158 final.} This ‘next phase’ ‘would be more intrusive,’ ‘coordinating or even harmonising taxes,’ with EU institutions ‘able to insist on certain spending
priorities. Work to make ex-ante coordination of economic policies under EU law binding has begun, and the use of ‘solidarity mechanisms’ (i.e. financial conditionality) as the basis of binding debt contracts is now commonplace. In late 2015, Commission minutes confirmed that Stage 2 of the plan to bring binding debt contracts within the EU legal order was underway, while others in the European Legal Service have energetically called for the removal of the ‘no bailout’ rule, in order to eliminate the last irritants of sovereignty hindering the centralisation of budgetary policy.

As a result, it is difficult to take a ‘photo finish’ of the Union architecture. It is clear, however, that the present framework has met the limits of the Treaties. The proposals for a centralised power of EU institutions to rewrite national budgets are deeper extensions of the four-pillar model identified by this Chapter, but they have no legal basis in the Treaty.

Nevertheless, the foundation-stones of the new model have been sunk, and the layout is clearly classifiable from the perspective of fiscal federalism theory. Whether or not the architecture grows upwards in the future, the basic pillars of the proto-fiscal union are already in place.

5.2 Classification of the New Model

From the perspective of fiscal federalism theory, the economic and legal taxonomy of a given federal model depends on its placement on a continuum between (centralised) fiscal union and (decentralised) fiscal federalism. Beyond either extreme of this spectrum lie non-federal systems of government: A ‘confederation’ is one in which the central authority has no sovereignty independent of the cumulative powers of its individual members; and a unitary state is one in which the central government is supreme: tax and revenue powers may be devolved by statute but the

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1449 See: Section 8.5. European Commission, Minutes of the 2158th meeting of the Commission (24 October 2016), 21; European Commission, Minutes of the 2143rd meeting of the (21 October 2015), 19-20; European Commission, Minutes of the 2145th meeting (11 November 2015), 19-20.
1450 European Commission, Minutes of the 2143rd meeting (21 October 2015).
1451 Merino (2012) 1632: ‘The rational of the prohibition, founded on the logic that Member Stats remain sovereign for their budgets, would not exist any more should... Member States no longer be sovereign for their budgetary decisions.’
1452 Merino (2012), 1631.
1453 As reported by the Commission Blueprint (2012), 26, ‘the innovations brought... are reaching the limit of what is possible under the current Treaties... once adopted, the EU will largely have exhausted the limits of its legislative competence’.
central government may abrogate the acts of devolved governments or unilaterally curtail their powers. \footnote{Kenneth Wheare, Federal Government (Oxford University Press 1987), 31-32.}

\vspace{0.5em}

\textbf{Figure 35  Institutional Constraints on Sub-Federal Budgetary Policy} \footnote{Adapted from: Eyraud and Gomez Sirera (2014), 9. For similar classification systems see: Ter-Minassian and Craig (1997); Joumard and Kongsrud (2003).}

<table>
<thead>
<tr>
<th>Federal States</th>
<th>Less sub-federal autonomy</th>
<th>More sub-federal autonomy</th>
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<tr>
<td>Direct Control of Sub-federal Fiscal Policy by the Centre</td>
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<td>Fiscal Rules</td>
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<tr>
<td>Imposed by centre</td>
<td>Negotiated</td>
<td>Self-imposed</td>
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<tr>
<td>Pure Market Discipline</td>
<td></td>
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The essence of ‘federalism’, by contrast, is the division of sovereign power between two ‘co-equally supreme’ states in which central and state-level governments are equal, autonomous and self-governing. \footnote{Wheare (1987), 10-15 (referring to member states and the federation possessing ‘distinct and independent portions of supremacy’); Oates, Fiscal Federalism (1972); Rodden (2006).} Certain tax and spending competences are exercised independently by the federal government, certain others are exercised independently by the states, and neither can exert control or curtail the competences of the other. Germany, the United States, Canada and Switzerland, to varying degrees, are all fiscal federations. \footnote{See Chapter 7.}

The difference between a unitary state and fiscal federalism is therefore the existence of two independent ‘sovereign’ fiscal capacities operating side-by-side. Within federal states, institutional arrangements for fiscal discipline fall along a spectrum from pure market discipline to centrally-imposed fiscal rules. A rich literature has developed to determine the optimum selection of legal attributes in a given constitutional and economic federal system, and that literature is applied in-depth in Chapter 7. \footnote{For surveys, see: Weingast, ‘Second generation fiscal federalism’ (2009); Inman (1997); Wibbels (2003).} For present purposes it suffices to state that the appropriate legal construction of a given federal model depends on where it sits on the spectrum between (fully centralised) fiscal union, \footnote{Sometimes referred to as the ‘centralised’ or ‘surveillance’ model in the European context: Hinarejos, 'Limits to Fiscal Integration' (2014); Hinarejos, Constitutional Perspective (2015); Ter-Minassian and Craig (1997).} and the ‘classical’ model of decentralised fiscal federalism, (known as ‘ideal-type’ federalism, ‘market-preserving federalism,’ or ‘self-preserving federalism’ in the public economics literature). \footnote{Sometimes also ‘competitive federalism.’ Ter-Minassian and Craig (1997). See also: Eyraud and Gomez Sirera (2014); Joumard and Kongsrud (2003); IMF, Macroeconomic Policy Lessons (2009), 40; Singh and Plekhanov (2005), 6; Livingston (1956); Riker (1964); Weingast, 'Market-Preserving Federalism and Economic Development' (1995); Qian and Weingast (1997); McKinnon, 'Market-preserving fiscal federalism' (1997); De Figueiredo and Weingast (2005); Oates, 'Towards a Second-Generation' (2005); Braun (2007); Weingast, 'Second generation fiscal federalism' (2009), 281.}
Occupying one end of the spectrum, highly-centralised fiscal unions such as Australia or Germany exhibit the ‘centralisation’ or ‘surveillance’ model, in which the central government exerts ‘such a degree of fiscal control that credit distinctions between the constituent states are almost non-existent.’

Occupying the other end of the spectrum lie highly-decentralised ‘classical’ or ‘ideal-type’ federations such as the United States, Switzerland, and Canada, which exercise no federal oversight of state-level finances, and in which state treasuries are not under the umbrella of a ‘fiscal union’ of the sort proposed in 2015 by the Commission.

Setting aside the EU’s idiosyncratic constitutionalism debate, the model in the EU Treaties also falls squarely upon the ‘classical’ or ‘market-preserving’ end of the federal spectrum. The EU’s ‘federal’ budget may be relatively small in comparison to most federations (which does not necessarily reflect the outsized scope of its legal competences) but, from the perspective of fiscal federalism, the model generally adheres to the ‘classical’ or ‘ideal type’ federalism: The Union and the Member States each have their own autonomous expenditure and revenue competences, and both are (in principle) supreme within their spheres.

The reforms identified in this chapter constitute a fundamental departure from that model. The layout of the architecture identified in this chapter constitutes the foundation of an as-yet inchoate - but highly centralised, model of centralised ‘fiscal union.’

In that regard, some terminological idiosyncrasies of EU politics must be remarked at the outset: In the federalism literature, ‘federalism’ is typically used to refer to decentralised systems of government, while ‘union,’ ‘unitary’ or ‘unionist’ are used to denote centralisation and those who advocate this course. In the economic literature, fiscal ‘union’ refers to the independent tax and expenditure capacities of the federal government, but it does not imply the mutualisation of finances or centralised control of sub-federal spending capacities. In EU politics, ‘federal,’ ‘federalism’ and ‘federalist’ are often used to denote the centralisation of decision-making power in the Union and

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1463 Bishop, Damrau and Miller (1989), 2.
1464 See Chapter 7, Section 7.2.3.
1465 See Chapter 7, Section 7.2.2.
1466 See Chapter 7, Section 7.2.4.
1468 Federal expenditures typically range from between 10-30% of GDP in comparative federations, compared to around 1% of EU GDP. Lamfalussy, ‘Macro-coordination’ (1989), 95. However while in Canada, the US, Switzerland and Germany, both the federal government and the state governments maintain a large civil service, the EU operates by effectively ‘co-opting’ Member State executives, so federal spending only needs to be large enough to maintain an ecosystem of legislators and enforcers. In short, EU institutions create laws, but national executives carry them out.
1469 In Ireland, ‘Unionist’ was first used to describe opponents to the Government of Ireland Bill 1886, which attempted to devolve powers to Ireland in specific areas and increase ‘federalisation.’ Similarly, in the United States, ‘Unionist’ was used to denote supporters of the federal government, while ‘Confederate’ denoted supporters of the secession of (southern) US states. Interestingly, in Canada the creation of a federal state was referred to as ‘confederation’, since Canadian provinces moved from a dominion under the UK parliament (a unitary state) to a decentralized federation wherein the provinces acquired new autonomy.
those who advocate this course.\textsuperscript{1470} ‘Fiscal union,’ as it is used by EU institutions in the Commission Blueprint and the Five Presidents’ Report, does not refer, as the literature on federalism does, to the existence of independent \textit{federal} tax and spending competences (which model the EU already has). It refers to the vertical centralisation of Member State tax and spending competences in the Union – or, as the Commission so puts it, to ‘a means to imposing budgetary and economic decisions on its members.\textsuperscript{1471} Indeed, if the reforms charted in this chapter are evidence of ‘federalisation,’ the model enunciated here is closer to a unitary state than any of the federations compared in Chapter 7.

The instruments which make up the ‘proto-fiscal union’ identified in this chapter can be divided into four pillars, as follows:

Pillar I is conditional financial assistance (Article 136(3) TFEU), which architecture is comprised of three ad-hoc bailout mechanisms (bilateral loans, the EFSF and the ESM), one permanent bailout mechanism (the ESM), and numerous ‘unconventional’ policy instruments deployed by the ECB, in particular the Outright Monetary Transactions (OMT) programme. This legal architecture is deconstructed in Chapter 5.

Pillar II is centralised fiscal governance (Articles 121, 126 TFEU). Under this pillar, new sanctions and reverse-QMV have been inserted into both limbs of the SGP, rendering the application of sanctions virtually automatic. This, combined with the operationalisation of the concept of a ‘significant observed deviation from the MTO’ has expanded the ‘hard law’ disciplines of EU surveillance from the 3% and 60% debt limits, to the whole panoply of economic, social and welfare decisions which constitute that balance.\textsuperscript{1472} As a result, budgetary recommendations now stretch into highly sensitive political areas, touching on everything from pensions and wage formation, to town planning and health care. This has been accompanied by a significant deepening of vertical legal restraints. The TSGC requires Member States to transpose a ‘balanced budget rule’ into their national legal systems, through binding (preferably constitutional) law guaranteed to be adhered through the national budgetary process.\textsuperscript{1473} This mechanism, though founded under public international law, is nonetheless interlaced with EU law: Regulation 473/2013 sets out binding requirements regarding the criteria, institutional activation and trigger for the TSGC;\textsuperscript{1474} Member States must put in place a correction programme regulated under Article 9 of Reg 473/2013;\textsuperscript{1475} and its implementation


\textsuperscript{1471} Commission Blueprint for a deep and genuine EMU COM(2012) 777 final.

\textsuperscript{1472} Reg 473/2013 rec 28, for instance, states that ‘budgetary measures might be insufficient to ensure a lasting correction of the excessive deficit’ and requires a far-reaching economic programme encompassing social and welfare policy.

\textsuperscript{1473} Art 3(1)(a) TSCG. See: Section 8.3.2.

\textsuperscript{1474} Art 5(2)(a) Reg 473/2013 See: Section 8.3.2.2, 8.3.2.3.

\textsuperscript{1475} Art 5(2) TSCG and Art 9 Reg 473/2013. See: Section 8.3.2.4.
is monitored by the Commission and Council in the context of the existing EU law framework of the SGP. This architecture is deconstructed in Chapter 8 (Section 8.3.2).

Pillar III is centralised macroeconomic governance. The introduction of a new ‘Macroeconomic Imbalance Procedure’ and ‘Excessive Imbalance Procedure’ (MIP/EIP) has expanded the sanction-backed ‘hard law’ European budgetary framework to virtually all areas of fiscal, economic and social policy. As will be seen in Chapter 7, Member States are now compelled - by instruments of EU law - to incorporate EU economic policy outputs into their national budgetary decision-making process before embarkation on the national parliamentary enactment process. This architecture is deconstructed in Chapter 8 (Section 8.2).

Pillar IV is centralised governance of budgetary frameworks: All of these procedures are now fully integrated into the European Semester, an annual coordination cycle established under the ‘six pack’, that integrates economic governance procedures with Member State budgetary frameworks (as amended under Directive 2011/85/EU and Regulation 473/2013 of the ‘six pack’ and ‘two pack’). This architecture is deconstructed in Chapter 8 (Section 8.2).

All of these machineries, their legal bases, and their operation are examined in-depth in the remaining three chapters of this thesis. For present purposes, it is sufficient to remark here that, far from mere administrative convenience, these procedures are imbued with vertical effects because EU legislation has made substantial amendments to national fiscal frameworks which create binding interlinkages with these machineries. Secondary EU law now sets out binding requirements for, inter alia, Member State budgetary frameworks, draft budgetary plans, medium-term fiscal plans and SCPs, MTO adjustment paths, budgetary forecasts, budgetary planning, technical assessments, and national fiscal rules. Secondary EU legislation has not only broadened and deepened European economic governance at EU level, it has stretched athwart the gap between legal orders and made amendments directly to budgetary frameworks and budgetary laws at national level. The border between EU and national competence is now criss-crossed with

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1476 Art 5(2) TSCG and Art 9 Reg 473/2013. See: Section 8.3.2.4.
1477 Bekker (2013), 3; Tholoniat (2010); Craig, 'Pringle' (2013).
1478 See: Sections 8.2.1 and 8.3.3. The European Semester is set out under Art 2-a Reg 1466/97 as amended by Art 1 Reg 1175/2011. The ‘six pack’ and ‘two pack’ made extensive amendments to Reg 1466/97, and is supplemented by Reg 473/2013 for Euro Area Member States. Directive 2011/85/EU sets out extensive requirements for budgetary frameworks and national fiscal rules.
1479 See Chapter 8, in particular: Reg 1466/97 (as amended); Directive 2011/85/EU, in Sections 8.2 and 8.3.
1480 Art 3(1) Reg 473/2011.
1481 Art 6(1) Reg 473/2011.
1483 Arts 4, 5 Reg 1466/97 (as amended); Art 4(1) Reg 473/2013.
1484 Art 4 Directive 2011/85/EU.
1485 Arts 4, 6(2) Directive 2011/85/EU; Art 5 Reg 473/2013.
1486 Art 15(2) Reg 479/2009 states: ‘The Commission (Eurostat) may amend actual data reported by Member States … where there is evidence that actual data reported by Member States do not comply with the requirements of [completeness, reliability, timeliness and consistency of the statistical data].’
1487 Arts 5, 6(2) Directive 2011/85/EU; 5 Reg 473/2013.
legal sutures that bind national budgetary outcomes to EU processes, rules, and recommendations. While it remains that technical assessments and economic policy recommendations issued at EU level are not technically binding under of their own force, secondary EU now requires Member States have legal vehicles in place to meet these prescriptions at the border between legal orders and shuttle them into national law. From the perspective of fiscal federalism theory, this is an institutional configuration that is far more apt to unitary states than any of the federations touched upon this thesis. As Fabbrini observes:

‘Indeed, in the United States, because of the federal system of government, it would arguably be impossible for the federal government to mandate to the states the incorporation of specific budgetary rules in the state constitutions and to require state legislatures and governors to submit draft budgets for prior approval in Washington DC.’

5.3 Demands on the European Legal Order and Operational Hypotheses

The demands placed on the European legal order by these reforms are significant. The emergent federal architecture supplants a legal pillar of fiscal sovereignty (an entrenched ‘no-bailout’ law) for a legal feature of unitary states: Financial assistance and centralised legal governance of sub-federal economic competences. This hearkens to an extremely centralised model of fiscal union that appears unfaithful to the original constitutional bargain. First, according to the Treaty drafters (and this thesis) hard budget constraints and individual exposure to market discipline are indispensable requirements for compliance with the fundamental guiding principles price stability, sound public finances, and a sustainable balance of payments. The hypothesis of this thesis in that regard is that systems of fiscal federalism which substitute hard budget constraints for centralised legal governance are not compatible with the guiding principles of price stability and fiscal discipline, and are not compatible with the European legal order. Second, any model of European fiscal federalism must preserve the fiscal sovereignty of the twenty-eight constitutional democracies which form the basis of its legal order. The hypothesis of this thesis in that regard is that any machineries of public economics which trespass on the tests for democratic legitimation under Member State ‘constitutional identity’ and ‘ultra vires’ review jurisdictions will not take effect in the legal system, and will not be compatible with the European legal order, de lege lata or de lege ferenda.

This raises three operational hypotheses tested in the remaining three chapters of this study:

[Chapter 6] First, financial assistance and centralised legal governance violates the preconditions of hard budget constraints and market-discipline indispensable to the mandate for stable prices, sound

1488 Fabbrini (2013) [34] (emphasis in original).
1489 Kelemen (2015), 388, notes: ‘With the establishment of a permanent bailout fund in the ESM, the European Union formalised the burial of the no-bailout provisions of the Maastricht Treaty.’ See also: Craig, ‘Pringle’ (2013); Lenaerts, 'Constitutional framework' (2014); Kelemen and Teo (2012), 4; Armstrong (2013); Besselink and Reestman (2012), 7 (referring to a new ‘composite’ constitutional order of Europe); Edoardo Chiti and Gustavo Teixeira (2013).
public finances and a sustainable balance of payments, and so must not conform to the legal architecture for fiscal federalism inscribed in the constitutive treaties of the Union as a matter of law. Chapter 6 examines that question against a doctrinal analysis of the Pringle v Ireland, Gauweiler v Bundesbank, and the various ‘ESM’ bodies of litigation.

[Chapter 7] Second, financial assistance and centralised legal governance violates the essential preconditions of hard budget constraints indispensable to the mandate for stable prices, sound public finances and a sustainable balance of payments, and so must not comply with those conditions as a matter of economic fact. Chapter 7 examines this question a posteriori through empirical and theoretical analysis of the literature on public finance and public economic data.

[Chapter 8] Third, financial assistance and centralised legal governance must not conform to the allocation of competences in the Treaty; must not conform to the boundaries between EU law and Member State fiscal sovereignty; and the good functioning of the new model must now be dependent on the operation of legal machineries which are beyond the limits of the EU legal order. In pursuit of that hypothesis, Chapter 8 conducts a piece-by-piece deconstruction of the economic governance framework to identify instruments which explicitly or implicitly trespass on constitutional boundaries of fiscal sovereignty set out in the rulings of national constitutional courts.

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1490 Pringle I (Ireland Supreme Court); Pringle v Ireland (View of AG Kokott); Pringle v Ireland.
1491 Gauweiler I (Germany); Gauweiler II (Opinion of AG Cruz-Villalón); Gauweiler II (CJEU); Gauweiler III (Germany).
1492 Pringle I (Ireland Supreme Court) [8.14]; Re ESM I (Germany); Re ESM II (Germany) [161]-[162]; ESM (Austria) [104];[105]; Opinion 25/2011 on the ESM (Finland); Opinion 13/2012 on the ESM (Finland); ESM & TSCG (Poland), 305; ESM (Estonia) [105]-[106], [144].
6. Price Stability and Fiscal Discipline as a Matter of Law
6. The ‘Pringle Hypothesis’ as a Matter of Law

The purpose of this chapter is to examine the comportment of the legal architecture for conditional financial assistance with the constitutive treaties of the Union as a matter of law. In *Pringle v Ireland*, the ECJ ruled that conditional financial assistance is both contemplated by the existing Treaties and capable of replacing the logic of the markets in fulfilling the requirement of fiscal discipline. In that case, the ECJ interpreted Articles 122-125 against the teleology of price stability and fiscal discipline identified in this thesis and sanctioned the economic abrogation of the ‘no-bailout rule’ through the amendment of Article 136(3) TFEU, instead entrusting the task of budgetary discipline to centralised legal governance under Articles 121 and 126 TFEU. This surgery was effected subject to a single, overarching *ratio decidendi*: Conditional financial assistance is compliant with the principles of price stability and fiscal discipline in so far as EU economic governance is competent, *de jure* and *de facto*, to preserve the incentive for budgetary discipline. Were it not so, the conditions set out by the court in *Pringle v Ireland* would not be met, and the financial assistance would be unlawful under the Treaties. The court held:

> ‘It is apparent from the preparatory work relating to the Treaty of Maastricht that the aim of art.125 is to ensure that the Member States follow a sound budgetary policy. The prohibition laid down in art.125 TFEU ensures that the Member States remain subject to the logic of the market when they enter into debt, since that ought to prompt them to maintain budgetary discipline. Compliance with such discipline contributes at Union level to the attainment of a higher objective, namely maintaining the financial stability of the monetary union. Given that that is the objective pursued by art.125 TFEU, it must be held that that provision *prohibits the Union and the Member States from granting financial assistance as a result of which the incentive of the recipient Member State to conduct a sound budgetary policy is diminished.*

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1495 In order to be constitutional, the legal architecture for conditional financial assistance must also comport with the fundamental principles binding on the mandate for EMU under Article 119(3) TFEU as a *matter of fact* – an hypothesis examined in Chapter 7.

1494 The Court of Justice sat as a plenum with all 27 judges, twelve Member States were involved in the proceedings, and eleven governments intervened, while Ireland was already engaged as a party. For the first time in EU history, the European Council also intervened, in addition to the Commission and the Parliament.

1495 *Pringle v Ireland* [136]-[137].

1496 See, e.g., *Gauweiler III (Germany)* [3](c) ‘Against this backdrop, one must assume that the Court of Justice considers the conditions it specified to be legally binding.’

1497 *Pringle v Ireland* [136]-[137] (emphasis added)
Within the European legal order, this *ratio decidendi* is the gateway through which European fiscal federalism passed from a decentralised ‘ideal-type’ founded on hard budget constraints to a ‘centralised’ model of financial assistance and legal governance. The stated assumption behind this surgery is what is referred to hereafter as the ‘Pringle Hypothesis’: that centralised legal governance is both contemplated by the existing treaties and competent to replace market discipline in fulfilling the precepts of fiscal discipline under 119 TFEU. In *Pringle v Ireland*, the court ruled that this teleology will be fulfilled where three conditions are met: (1) financial assistance does not discharge liability for debt; 1498 (2) financial assistance is attached to strict conditionality ‘to ensure that the member States pursue a sound budgetary policy’; 1499 and (3) where such support is *ultima ratio* indispensable to safeguard the financial stability of the euro area. 1500

The effect of this is that it is now centripetal legal governance which is relied upon to carry on the mantle of fiscal discipline. Of the three conditions named by the court, only strict conditionality is of disciplinary force, and, as will be seen, this is exclusively defined and enforced through the EU’s fiscal governance procedures. 1501 This abrogates a legal instrument of fiscal sovereignty (an entrenched ‘no-bailout’ law) and sinks a legal pillar of fiscal union (centralised fiscal governance) in its place.

In order for the ‘Pringle Hypothesis’ to provide a true account of the compatibility of this pillar with EU law, this hypothesis must not only be correct as a matter of economic fact (an hypothesis examined in Chapter 7), but as a matter of law: That is, conditional financial assistance must fall within the range of instruments *considered by the Treaty drafters* as conducive to the logic of the markets and fiscal discipline. It is uncontroversial that both fiscal rules and market discipline are used in advanced federations for budgetary discipline. However, they yield federal systems of starkly opposite character: Centralised debt constraints imply an abdication of budgetary sovereignty and a mutualisation of risk; bailout prohibitions entrench fiscal sovereignty and market discipline. As Watts cautions of the literature on comparative federalism, suitability for purpose cannot be assumed: ‘rarely do institutional structures applied to different countries work in the same way.’ 1502

Moreover, one might query whether legal regulation is the constitutional equivalent to market

1498 This is intended to ‘ensure that the Member States remain subject to the logic of the market when they enter into debt’. In so far as the recipient Member State ‘remains responsible for its commitments to its creditors in respect of its existing debts’, such that the debtor remains liable to repay the financial assistance, the ‘logic of the markets’ is preserved: *Pringle v Ireland* [137]-[139].

1499 *Pringle v Ireland* [135]-[137], [143].

1500 Article 125 TFEU prohibits instruments ‘as a result of which the incentive of the recipient Member State to conduct a sound budgetary policy is diminished.’ *Pringle v Ireland* [142]-[145]

1501 As stated by the court, conditionality ensures only that ‘the recipient Member States *comply with measures adopted by the Union … to ensure that the Member States pursue a sound budgetary policy.*’ *Pringle v Ireland* [143]. [Emphasis added]

Notwithstanding Pringle v Ireland, that analysis remains integral because the text of the Treaty is but the litmus paper for determining whether EU law coheres with much deeper constitutional boundaries underlying the EU legal order itself. As shown in Chapter 1, it is not the view of the Court of Justice which is dispositive where the boundaries of the EU are concerned. The EU is founded on conferred powers: The ECJ can examine the Union’s boundaries from within its ramparts, but it is not the final arbiter of how far its territory extends. It suffices to recall that national constitutional courts ‘have never acquiesced in the doctrine of the absolute precedence of Community law.’ They remain in agreement ‘that the transfer of sovereign powers, or “competences” to the EU is limited.’ Within its borders the EU is supreme, but this is again so only ‘so long as’ it remains subject to the substantive conditions placed upon the exercise of those competences.

In simple, the Union may paste over gaps in its primary law foundations in order to build new structures upon it, but the fault lines running through the Treaties remain a matter of national constitutional law. In the realm of monetary union, this means fiscal sovereignty, the core of constitutional identity. This chapter is therefore concerned with whether conditional financial assistance is genuinely reconcilable with the constitutional fault lines underlying the divisions inscribed in the Treaties. It seeks to diagnose any possible inconsistencies or contortions entailed with interweaving financial assistance into the allocation of competences and public finance provisions under Articles 2(3), 5(1), and 121-125 TFEU. Discomfiture with either of these textual criteria will provide the first testable indication that an amendment to the federal structure has exceeded the boundaries of the European legal order and provide directions for Chapters 7-8. The analysis proceeds as follows:

Section 6.1 sets out the legal architecture of conditional financial assistance. Since the EFSF and EFSM programmes have been subsumed within the ESM, this is now essentially

1503 Sugar Quotas III (Czech Republic).
1504 Theil (2014), 608.
1505 As acknowledged in Gauweiler II (Opinion of AG Cruz-Villalon) [215], the economic and monetary union is ‘bound’ ‘by a set of principles relating both to its objectives and to its boundaries, which overall represent its “constitutional framework”.’ See, for other statements to that effect: Germany: Re Lisbon (Germany) [221]; Denmark: Carlsen (Denmark) [13]; Poland: ESM & TSGC (Poland) [6.3.1].
1506 Re Lisbon (Germany), 210: ‘The principle of conferral is therefore not only a principle of European law… it includes constitutional principles from the Member States.’
comprised of two instruments: The European Stability Mechanism (ESM), and the Outright Monetary Transactions Programme (OMT).\footnote{The ad-hoc Greek loan facility, the EFSF and the OMT are all attendant or predecessors of the new legal framework under Art 136(3) TFEU and the ESM.}

Section 6.2 briefly summarises the constitutional challenges to these legal instruments in the \textit{Pringle v Ireland} and \textit{Gauweiler v Bundesbank} litigation.

Section 6.3 analyses the ESM and OMT against the allocation of competences under the Treaties. It concludes that the present configuration of the ESM and OMT cannot both be reconciled with the division of competences for economic and monetary policy in Articles 2(3), 3(1)(c) and 5(1) TFEU without overlap. The ESM and OMT are constructed upon, rather than within, the boundaries between (Union) monetary policy and (Member State) economic policy, and one constitutional court has already ruled that the latter has exceeded the allocation of competences.

Section 6.4 examines the comportment of conditional financial assistance with the provisions governing public finance in Articles 122-125 TFEU. Adopting the interpretation of the ECJ in \textit{Pringle v Ireland}, it concludes that public-sector financial instruments will be lawful where three conditions are met: (1) Member States are exposed to market discipline; (2) the incentive for budgetary discipline is preserved, and (3) the instrument is necessary for the financial stability of the monetary union.

The analysis concludes, unavoidably, that conditional financial assistance simply does not fall within the range of instruments contemplated by the Treaty as competent to ensure fiscal discipline and price stability. This emerges from an analysis of the allocation of competences (within which the ESM does not sit) and an analysis of the substantive provisions of Articles 119-126 of the TFEU (to which the ESM does not adhere). When the sovereign debt crisis arrived, there was no legal competence and no institutions allowing either the Union or the Member States to share the burdens of the crisis, and Article 125 TFEU expressly precluded the possibility of bringing one into existence.\footnote{Edoardo Chiti and Gustavo Teixeira (2013), 698; Stark (2013), 543; Peroni (2013), 189 (Articles 123-125 ‘excludes any form of financial and economic solidarity between EU member States’).} By restoring an interpretation of the Treaty which was rejected under Article 104-104a of the Commission’s 1990 draft Treaty at Maastricht, the Court of Justice would seem to have reached back through history, brushed aside the stated will of the Treaty drafters, plucked the (rejected) Commission draft Treaty from the floor of Maastricht, and enacted it into primary law.

This conclusion wholly coheres with the ratio of \textit{Pringle}: the new architecture is compliant with the Treaty \textit{in so far as} EU economic governance is sufficient, \textit{de jure} and \textit{de facto}, to preserve the
incentive for budgetary discipline (and so safeguard price stability). This chapter simply states, uncontroversially enough, that the legal architecture of fiscal federalism can only be lawful in so far as the conditions set out under the Treaty (and by the ECJ) are indeed met.

Nonetheless, it cannot be avoided: Since the creation of the EFSM and EFSF, there have been four conditional bailout mechanisms: One under the EU law (the EFSM), one under private law (the EFSF), one in public international law (the ESM) and two by the ECB (the SMP and OMT). These programs are virtually indistinguishable in terms of their objectives, triggers, tasks, instruments, and conditionality. Yet, depending on the angle of challenge, these mechanisms are found to both occupy and not occupy the same competences; they have and have not the same objectives; and the criteria by which one mechanism complies with ‘no bailout rule’ are not met by another, then vice-versa. For example:

[6.3.1] Secondary-market bond purchases for stabilising interest rates are economic policy when the ESM does it but monetary policy when the ECB does it; [6.3.4] economic conditionality adopted under binding EU law is not EU law because it is drafted on behalf of Member States, but [6.3.2] Member State conditionality is only consistent with Articles 2(3) and 5(1) TFEU because Member States have no competence to devise conditionality; [6.4.3.2] the ESM is compatible with Article 125 TFEU because financial assistance is subject to strict conditionality, but [6.4.3.2] Articles 14 and 18 of the TESM are not subject to any conditionality whatsoever; [6.4.3.3] financial assistance must be ultima ratio indispensable for the stability of the monetary union, but [6.4.3.3] financial assistance under Articles 14, 15 and 18 TESM can only be given when there is an absence of financial instability, and so on.

The application of Pringle to the emergent architecture repeatedly ‘fails on its own terms.’ Adams et al agree: ‘Pringle makes painfully clear’ that the relationship of the ESM to the EU ‘is difficult to square within the framework of EU law.’

6.1 The Legal Architecture of Conditional Financial Assistance

6.1.1 The Bilateral Greek Loan Facility

Conditional financial assistance emerged with the announcement of the €110bn package of bilateral loans to Greece (BGLF) on 1 May 2010. The loan facility was constituted on an

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1510 Pringle v Ireland [136]-[137]. This ratio is now routinely used, in cases such as Gauweiler to evaluate novel aspects of the EU’s new fiscal model, and this thesis is no different. It is also substantively the same test the BVerfGE used to assess the constitutionality of EMU in Brunner (Germany) [84]-[89].
1511 See, e.g., Gauweiler III (Germany) [3][c] ‘Against this backdrop, one must assumed that the Court of Justice considers the conditions it specified to be legally binding.’
1512 Gunnar Beck, 'The Court of Justice, legal reasoning, and the Pringle case - law as the continuation of politics by other means' (2014) 39 EL Rev 234, 244.
1514 For the announcement, see: Eurogroup, 'Statement of the Eurogroup' (2 May 2010).
intergovernmental basis as a loan syndicate, with the Euro Member States providing €80bn,\textsuperscript{1515} and the IMF providing the remaining €30bn.\textsuperscript{1516} Policy conditionality was set out in a Council Decision, incorporated into an Intercreditor Agreement, and integrated into the normal SGP procedure.\textsuperscript{1517} The first disbursement of €20bn took place at a floating rate (3-month Euribor rate + 300bps for the first three years, and 3-month Euribor + 400bps thereafter).\textsuperscript{1518}

6.1.2 The European Financial Stability Mechanism

The Greek bailout failed to stop contagion, and on 11 May 2010 the Council adopted Regulation 407/2010 establishing the EFSM, a bailout mechanism with the ability to raise €60bn against the EU budget for a loan volume of €40bn.\textsuperscript{1519} EFSM funding of €22.5bn was first issued to Ireland in December 2010 at (cost + 292.5bps), with a maximum maturity of 7.5 years.\textsuperscript{1520} In May 2011, €26bn was issued to Portugal at (cost + 215bps) with a maximum average maturity of 7.5 years.\textsuperscript{1521} These cost were later watered-down over the course of nearly two-dozen successive amendments, such that by October 2011, the price of the EFSM loans was reduced to cost, while the average maximum maturity was extended - first to 12.5 years (October 2011), then to 19.5 years (June 2013).\textsuperscript{1522}

6.1.3 The European Financial Stability Facility

The EFSF was founded alongside the EFSM, outside of EU law, in the form of a Luxembourg-incorporated special-purpose vehicle.\textsuperscript{1523} Endowed with an initial effective loan volume of €440bn,

\textsuperscript{1515} Member State contributions were pooled under a single loan agreement signed by the Commission on their behalf with contributions assessed by an adjusted ECB capital key. See: The Intercreditor Agreement between Belgium, Germany, Ireland, Spain, France, Italy, Cyprus, Luxembourg, Malta, the Netherlands, Austria, Portugal, Slovenia, Slovakia and Finland (8 May 2010) and 'Euro 80,000,000,000 Loan Facility Agreement between the Member States whose Currency is the Euro and KfW acting with the benefit of the guarantee of Germany (as Lenders) and the Hellenic Republic (as Borrower) (8 May 2010); European Commission, 'Adjustment Programme for Greece' (2010), 26.

\textsuperscript{1516} European Commission, 'Adjustment Programme for Greece' (2010), 8.

\textsuperscript{1517} Conditionality was designed to be consistent with EU policy conditionality: Arts 4(1)-(2) of the Greek Intercreditor Agreement (8 May 2010) and rec (6) of the Greek Loan Facility Agreement. See: Council Decision 2010/320/EU.

\textsuperscript{1518} Consisting of €14.5bn from the Euro countries and €5.5bn from the IMF. This cost does not include an additional up-front service fee of 50bps. European Commission, 'Adjustment Programme for Greece' (2010), 1, 26.

\textsuperscript{1519} See: Chapter 2, Section 2.3.1.4. Art 2(2) of the EFSM Reg states that the outstanding amount of loans to be granted shall be limited to the margin available under the own resources ceiling for payment appropriations (which shall not exceed 1.24% of the sum of all the Member States’ GNIs under Art 3(2) of Council Decision 2007/436/EC of 7 June 2007 on the system of the European Communities’ own resources [2007] OJ L 163/17.


\textsuperscript{1521} Art 1 Council Implementing Decision 2011/334/EU granting Union financial assistance to Portugal [2011] OJ L159/88.


\textsuperscript{1523} The decision to create the EFSF in the Council may be found here: Council of the EU, 'Decision of the Representatives of the Governments of the Euro Area Member States Meeting Within the Council of the European Union' (Doc 9614/10, 10 May 2010)
The EFSF was financed by debt instruments against an ‘irrevocable and unconditional guarantee’ issued by the EMU Member States according to an adjusted ECB capital key.\textsuperscript{1524} The EFSF’s conditional financial instruments in many ways presaged the ESM,\textsuperscript{1525} and its procedures were similar: Conditionality was negotiated by the Commission,\textsuperscript{1526} and, once approved by the Eurogroup,\textsuperscript{1527} incorporated into Council Decisions and fed through the SGP framework.\textsuperscript{1528} The EFSF was employed in November 2010, as part of the €85bn support package for Ireland,\textsuperscript{1529} in May 2011, as part of a €78bn rescue package for Portugal,\textsuperscript{1530} and in 21 July 2011 as the method of disbursement for €110bn support programme for Greece.\textsuperscript{1531}

The cost of EFSF assistance (cost + 200bps for the first three years and 300bps thereafter, with a maximum maturity of 7.5 years) was decidedly less punitive and also subsequently watered down.\textsuperscript{1532} In July 2011, the cost of funding was reduced to 3.5% (close to cost) and maximum maturities were extended to 30 years, with a grace period of 10 years.\textsuperscript{1533} By August 2014 the final weighted average maturity as of August 2014 was 20.8 years for Ireland and Portugal, and 32.38 years for Greece.\textsuperscript{1534}

\textsuperscript{1524} http://register.consilium.europa.eu/doc/srv?l=EN&f=ST\%209614\%202010\%20INIT

\textsuperscript{1525} Decisions on financing and capital calls were taken by unanimity: Arts 3,10 EFSF Framework Agreement.

\textsuperscript{1526} Art 2(1)(a) EFSF Framework Agreement. For comment: Armstrong (2013), 606.


\textsuperscript{1530} Art 2(8)-(9) EFSF Framework Agreement. The cost of funding includes an up-front service fee of 50bps.

\textsuperscript{1531} European Council, Statement by the Heads of State or Government of the Euro Area and Eu Institutions (2011).

\textsuperscript{1532} EFSF, ‘Lending Operations’ (EFSF, 14 August 2015) <http://www.eufs.europa.eu/about/operations/index.htm> accessed 25 February 2015. The explicit aim of these programmes was to insulate government debt from the marketplace: ‘This programme will be designed, notably though lower interest rates and extended maturities, to decisively improve the debt sustainability and refinancing profile of Greece.’ European Council, Statement of 21 July 2011 (2011).
6.1.4 The Amendment of Article 136(3) TFEU

The European rescue packages posed acute legal problems under the Treaties. First, as the German Chancellor insisted two months before the first EU bailout: ‘We have a treaty under which there is no possibility of paying bailouts to states in difficulty.’ Second, it was doubtful as to whether the Union possessed the competence under the Treaty establish the EFSM. The legal basis for the EFSM had been Article 122(2) TFEU, which permits Union financial assistance to a Member State which is ‘threatened by severe difficulties caused by natural disasters or exceptional circumstances beyond its control.’ However, it was widely doubted among legal commentators that this condition was met. At the very least, several tranches covered liabilities that were clearly self-inflicted. For example, the EFSM was last used in July 2015 to provide a €7.16bn bridge loan to Greece, which only became necessary in the first place because Greece had repudiated its bailout programme in 2014 and refused to recognise the troika, such that by March 2015 Greece had a gross debt of nearly 180% GDP and remained ineligible to access the €7.2bn remaining in its bailout programme. The alternative justification, that the bailouts would be lawful even where the exceptional circumstances were ‘self inflicted,’ also stretched credulity.

So insuperable were these legal difficulties that the March 2010 Task Force that had been assigned to investigate the legality of a bailout mechanism concluded returned empty-handed - there was no legal way to enact a bailout mechanism without an amendment to the Treaties. Yet by that time, a combined €198bn in bailouts had been issued under three separate legal instruments. The illegality of these instruments was tacitly acknowledged by the European Council, which concluded that Article 122(2) ‘should not be used for such purposes’; and by the ECJ in Pringle, which concluded: ‘Article 122(2) TFEU does not constitute an appropriate legal basis for any financial assistance from

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1535 Illmer (1 March 2010).
1536 Art 122(2) TFEU (emphasis added).
1537 Palmstorfer (2012) 780: according to the ejusdem generis principle, since natural disasters and ‘exceptional occurrences’ are ‘mentioned in the same breath’, Article 122(2) could only apply, at the very least, to situations in which the difficulties were unpreventable or unforeseeable by the Member State.’ See also: Jonathan Tomkin, ‘Contradiction, Circumvention and Conceptual Gymnastics: The Impact of the adoption of the ESM Treaty on the State of European Democracy’ (2013) 14 German LJ 169, 171; Seyad (2011), 423.
1539 At that point, so the argument goes, the market-discipline teleology of the ‘no bailout’ rule would no longer apply, because the choice would no longer be between market discipline and bailouts, but between default and bailouts. Athanassiou (2011), 564-565; Merino (2012). However, this was presumably seen as non-sensical: if Member States could spend themselves into a bailout then the prohibition on bailouts is meaningless
1540 ‘The setting up of a crisis resolution framework requires further work. As it may imply a need for Treaty changes, depending on its specific features, it is an issue for the European Council.’ Task Force, Strengthening Economic Governance (21 October, 2010).
1541 European Council Conclusions of 16-17 December 2010, rec 1.
the Union to Member States who are experiencing, or are threatened by, severe financing problems.’¹⁵⁴²

For this reason, in December 2010 - less than a year since the Lisbon Treaty had entered into force - the European Council agreed ‘a limited treaty change required to that effect, not modifying article 125 TFEU (‘no bail-out’ clause),¹⁵⁴³ and adopted Decision 2011/199/EU inserting a new Article 136(3) into the TFEU.¹⁵⁴⁴ The new article 136(3) states:

‘The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality.’

The impetus for this amendment was overtly legal. Fearing that the BVerfGE would declare the bailout funds *ultra vires* without a more convincing treaty basis, the logic was that the new paragraph would neutralise the threat of challenge by offsetting the ‘no bailout’ rule with a competing provision of equivalent normative value.¹⁵⁴⁵

Decision 2011/199/EU was adopted under the ‘simplified procedure’ of Article 48(6) TEU, which allows the European Council to amend all or part of the provisions of Part Three of the TFEU by unanimity, subject to two conditions:

(i) The procedure may only be used to amend the provisions of Part Three of the TFEU (‘Union policies and internal actions’); and

(ii) The procedure may not be used to increase the competences conferred on the Union.¹⁵⁴⁶

The legal basis for Decision 2011/85/EU therefore rests on two claims. The first is that allowing Member States to grant financial assistance under Article 136(3) TFEU is merely confirmatory of an already extant (and unwritten) right of the Member States to grant financial assistance that does not

¹⁵⁴² *Pringle v Ireland* [116].
¹⁵⁴³ European Council Conclusions of 16-17 December 2010, para 1; European Council, Conclusions of 28-29 October 2010, para 2.
¹⁵⁴⁶ Art 48(6) TEU.
affect EU competences.\textsuperscript{1547} This is so because monetary policy and economic coordination are both competences of the Union under Articles 2(3), 3(1)(c) and 5(1) TFEU - provisions in Part One of the Treaty. An amendment which either ‘increases and/or reduces the competences of the Union’ in those articles would breach Article 48(6) TEU, invalidating Decision 2011/199.\textsuperscript{1548} In that regard, Recital (6) of Decision 2011/199/EU,\textsuperscript{1549} the opinion of the Commission,\textsuperscript{1550} the opinion of the Parliament,\textsuperscript{1551} and the opinion of the ECB\textsuperscript{1552} all espoused the view that Article 136(3) TFEU merely ‘helps to explain, and thereby confirms … financial assistance is in principle compatible with Article 125 provided that it is indispensable for such safeguarding and subject to strict conditions.’\textsuperscript{1553}

The second claim is one of substantive EU law: That Article 136(3) TFEU does not create a new derogation from Article 125, but is merely confirmatory of an extant (and unwritten) \textit{lex specialis} to the ‘no bailout’ rule. This is so because Article 125 TFEU was not amended. Article 136(3) TFEU can be no wider than Article 125 as it was drafted at Maastricht, and ‘no bailout’ rule is still binding.\textsuperscript{1554} Moreover, as the ESM came into effect before Article 136(3) TFEU, the approval of the ESM is based on the ruling that the amendment does not much matter – the bailout mechanism was anyways permitted under the ‘no bailout’ rule.\textsuperscript{1555} These claims are examined below, but for present purposes it is sufficient to note that the legal justification for the Treaty amendment is that the Treaty amendment is entirely redundant.\textsuperscript{1556}

\textsuperscript{1547} In principle, the amendment would merely ‘confirm’ the right of Member States to grant financial assistance on an \textit{ultima ratio} basis, and would ‘not increase the competences conferred on the Union in the Treaties.’ See: Recs 1,6, European Council Conclusions of 16-17 December 2010, Annex 1. Gavin Barrett, ‘First Amendment? The Treaty Change to Facilitate the European Stability Mechanism’ (IIEA 2011): The amendment ‘is about iron-cladding competences rather than about creating new competences.’


\textsuperscript{1549} Decision 2011/199/EU, rec 6: ‘The amendment concerns a provision in Part Three of the TFEU and it does not increase the competences conferred on the Union in the Treaties.’

\textsuperscript{1550} ‘The new paragraph... confirms that the legal framework of the Union does not prevent those Member States from establishing a permanent stability mechanism enabling them to obtain any necessary financial assistance... It does not involve creating a new legal base which would allow the Union to take action that was not possible before this Treaty amendment.’ European Commission, ‘Opinion on the draft European Council Decision Amending Article 136 of the TFEU with regard to a stability mechanism for Member States whose currency is the euro’ COM(2011) 70 final.

\textsuperscript{1551} European Parliament resolution of 23 March 2011 on the draft European Council decision amending Art 136 TFEU with regard to a stability mechanism for Member States whose currency is the euro (C7-0014/2011 - 2010/0821 (NLE)).

\textsuperscript{1552} ECB, Opinion of the ECB of 17 March 2011 on a draft European Council Decision amending Art 136 of the TFEU with regard to a stability mechanism for Member States whose currency is the euro (CON/2011/24), para 5.

\textsuperscript{1553} \textit{Ibid}, para 5.

\textsuperscript{1554} An amendment modifying Article 125 would have been explicitly outside the bounds, as stated by the European Council, of a limited amendment ‘not modifying article 125 TFEU (“no bail-out” clause).’ European Council, Conclusions of 28-29 October 2010, para 2 [emphasis added]. See also: Christian Calleiss, 'From Fiscal Compact to Fiscal Union? New Rules for the Eurozone' (2012) 14 CYELS 101, 112.

\textsuperscript{1555} Pringle \textit{v Ireland} [183]-[185].

\textsuperscript{1556} See, e.g., Merino (2012), 1629, asserting that it has a mere ‘declaratory value.’
6.1.5 The European Stability Mechanism

It is on this basis that the Treaty Establishing the European Stability Mechanism (TESM) entered into force on 27 September 2012, nearly eight months before Decision 2011/199/EU.\textsuperscript{1557} The ESM is an intergovernmental organisation under public international law endowed with a total subscribed capital of €705bn and a total lending capacity of €500bn.\textsuperscript{1558} There are three aspects of the TESM’s legal provisions relevant to this thesis: Its funding model, the role of EU institutions in negotiating and enforcing financial conditionality, and the terms of its financial instruments.

First, unlike the EFSF, the ESM is endowed with its own authorised capital stock in the amount of €705bn.\textsuperscript{1559} Contributions are assessed in accordance with a modified ECB subscription key, and Article 8(4) commits its signatories ‘irrevocably and unconditionally’ to provide their contribution to the authorised stock and to meet all capital calls on a timely basis.\textsuperscript{1560} Importantly, Article 8(5) TESM states that Member State liability is limited to their allocated portion of the authorised capital stock:

‘The liability of each ESM Member shall be limited, in all circumstances, to its portion of the authorised capital stock at its issue price. No ESM Member shall be liable, by reason of its ownership, for obligations of the ESM.’\textsuperscript{1561}

Losses will be charged first against a reserve fund, secondly against paid-in capital, and thirdly against authorised unpaid capital under Article 9(3).\textsuperscript{1562} However, Article 25(2) TESM states that if one or more members fails to meet a capital call, a revised capital call will be made for which the remaining members will be jointly and automatically liable for the unpaid portion:

\textsuperscript{1557} The main feature of the ESM were set out in a term sheet attached to the European Council Conclusions of 24-25 March 2011, Annex II (Term Sheet on the ESM). For comment: Christoph Ohler, 'The European Stability Mechanism: The long road to financial stability in the euro area' (2011) 54 German Y Int Law 47. Decision 2011/199/EU came into effect 1 May 2013, after constitutional ratification in the Czech Republic.

\textsuperscript{1558} The ESM is governed principally by a Board of Governors (BoG), consisting of the Euro Area Finance Ministers, and by a Board of Directors (appointees of the Governors which may be delegated specific tasks) as well as a Managing Director (MD). The Commissioner for Economic and Monetary Affairs, the ECB President, and the Eurogroup President have observer status to the BoG. Art 4 TESM.

\textsuperscript{1559} Art 8(1) TESM.

\textsuperscript{1560} Arts 8(5), 11 TESM. The minimum paid in capital is set in Art 8(2), and may be amended. Capital calls are governed by Article 9 TESM. Art 9(1) allows the Governors to call in authorised unpaid capital at any time: ‘The Board of Governors may call in authorised unpaid capital at any time and set an appropriate period of time for its payment by the ESM Members.’ Art 9(2) empowers the Directors to call authorised unpaid capital by simple majority in the event that losses reduce the paid-in capital below €80,548,400. Art 9(3) then TESM states: ‘The Managing Director shall call authorised unpaid capital in a timely manner if needed to avoid the ESM being in default of any scheduled or other payment obligation... ESM Members hereby irrevocably and unconditionally undertake to pay on demand any capital call made on them by the Managing Director pursuant to this paragraph, such demand to be paid within seven days of receipt.’ Key decisions capable of increasing financial liability are taken by unanimity, the only exception being an ‘emergency’ stability support procedure which is taken by a super-QMV of 85% of votes cast (intended to give Germany a blocking minority): Art 5 TESM (Board of Governors) in conjunction with Art 4 TESM (voting procedures).

\textsuperscript{1561} Art 8(5), 11(1) TESM.

\textsuperscript{1562} Art 25(1) TESM reads: ‘1. Losses arising in the ESM operations shall be charged: (a) firstly, against the reserve fund; (b) secondly, against the paid-in capital; and (c) lastly, against an appropriate amount of the authorised unpaid capital, which shall be called in accordance with Art 9(3)."
‘If an ESM Member fails to meet the required payment under a capital call made pursuant to Article 9(2) or (3), a revised increased capital call shall be made to all ESM Members with a view to ensuring that the ESM receives the total amount of paid-in capital needed.’

Member States are therefore joint and severally liable for all the liabilities of the ESM up to the amount of their authorised capital stock. This funding model is discussed in Section 6.4.3.4, but it suffices to state here that it is perfectly and legally possible that a single stalwart contributor to the ESM may become automatically liable for all of its recalcitrant fellows’ pledged contributions to the ESM.

The second matter of concern is the significant entwinement between the TESM and EU law. First, once an ESM Member requests stability support, under Article 13(1) TESM and Article 6 Reg 472/2013 – a provision of secondary EU law - it is the Commission, in liaison with the ECB, which decide whether the conditions for financial assistance are met.\(^{1563}\) Second, under Article 13(3) TESM and Articles 6-7 of Reg 472/2013 – another instrument of Secondary EU law - the Commission, in liaison with the ECB, is tasked with negotiating the macroeconomic adjustment programme.\(^{1564}\) Importantly, under Article 7(2) of Reg 473/2013:

‘The Commission shall ensure that the [MoU] signed by the Commission on behalf of the ESM or the EFSF is fully consistent with the macroeconomic adjustment programme approved by the Council.’\(^{1565}\)

Once the MoU is agreed, the macroeconomic adjustment programme is simultaneously approved by the Eurogroup and inscribed in a binding Council Decision,\(^{1566}\) and approved by the BoG of the ESM (which are the same individuals), before being signed by the Commission on their behalf.\(^{1567}\)

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\(^{1563}\) Under those provisions, the BoG (or the Eurogroup under EU law - which are the same individuals - tasks the Commission, in liaison with the ECB, with assessing the existence of:- (a) a risk to the stability of the Euro Area as a whole or of its Member States, (b) the sustainability of public debt, and (c) the financing needs of the member. Under Art 13(1) TESM, the assessment of whether public debt is sustainable is expected to be conducted together with the IMF wherever appropriate and possible.

\(^{1564}\) Art 7(1) Reg 472/2013 reads: ‘Where a Member State requests financial assistance from one or several other Member States or third countries, the EFSM, ESM, EFSF or the IMF, it shall prepare, in agreement with the Commission, acting in liaison with the ECB and, where appropriate, with the IMF, a draft macroeconomic adjustment programme which shall build on and substitute any economic partnership programme under Regulation (EU) No 473/2013 and which shall include annual budgetary targets.’ In Pringle v Ireland [164], and Ledra (Opinion of AG Wahl) [58]-[59] the ECJ accepted that the obligation of the Commission to ensure the MoUs concluded by the ESM are consistent with EU law is a legal duty.

\(^{1565}\) Art 7(2) Reg 472/2013 states that the ‘macroeconomic adjustment programme’ will ‘build on and substitute’ any economic partnership programme already in place pursuant to Reg 473/2013. Art 13(3) TESM adds that such conditionality ‘shall be fully consistent with the measures of economic policy coordination provided for in the EFEU... including any opinion, warning, recommendation or decision addressed to the ESM Member concerned.’

\(^{1566}\) Art 7(2) Reg 472/2013.

\(^{1567}\) Art 13(3)-(5) TESM.
The Commission is then entrusted with monitoring and compliance, which is conducted entirely through EU law under the EU governance procedures dissected in Chapter 8.\textsuperscript{1568}

The third matter of concern is the terms of the ESM’s financial instruments. The TESM contemplates five support facilities, as follows:

Article 16 TESM: Loans may be provided where a Member States has lost access to market financing because lenders will only provide financing ‘at excessive prices that would adversely impact the sustainability of public finances’ subject to a macroeconomic adjustment programme.\textsuperscript{1570}

Article 14 TESM: Precautionary Financial Assistance may be granted in the form of a precautionary credit line (PCCL) or an enhanced conditions credit line (ECCL).\textsuperscript{1571} The PCCL is limited to recipients for which ‘the economic and financial situation is still fundamentally sound’ under a list of eligibility conditions.\textsuperscript{1572} An ECCL will be open to those who do not comply will all of the PCCL criteria but whose general economic and financial situation nonetheless ‘remains sound.’\textsuperscript{1573}

Article 15 TESM: Bank Recapitalisation Assistance is to be granted ‘if the roots of a crisis situation are primarily located in the financial sector and not directly related to fiscal or structural policies at the state level, and pose a serious risk to the Euro Area as a whole or the ESM Member.’\textsuperscript{1574}

Article 17 TESM: The Primary Market Support Facility (PMSF) consists of primary bond market interventions with the explicit purpose of allowing the Member State ‘to maintain or restore their market access.’\textsuperscript{1575} As interventions are taken on the basis of an ECB analysis, the

\textsuperscript{1568} The adjustment programme under Reg 472/2013 supersedes all other surveillance requirements under the SGP legislation: Arts 10-13 Reg 472/2013. Member States in receipt of financial assistance are automatically subject to enhanced surveillance (except those in the receipt of the PCCL, ECCL, or SMSF which have no additional surveillance requirements. Where the Commission concludes that a Member State has deviated from its adjustment programme, it will recommend the adoption of corrective measures; the Council will reach a decision of non-compliance, and the Member State ‘shall take measures aimed at stabilising markets and preserving the good functioning of its financial sector.’ See: Arts 2(3), 2(5), 3(3)-3(5), 7(7), Reg 472/2013.

\textsuperscript{1570} Art 15 TESM; Art 1 ESM Guideline on Loans (ESM 2014)

\textsuperscript{1571} Art 14 TESM; ESM Guideline on the PCCL and ECCL

\textsuperscript{1572} Pre-established eligibility conditions include respect for the SGP and MIP, sustainable government debt, a sustainable external trade position, the absence of bank solvency problems, and a track record of access to international capital markets: Art 2 ESM Guideline on the PCCL and ECCL.

\textsuperscript{1573} Art 2(4) ESM Guideline on the PCCL and ECCL.


\textsuperscript{1575} Arts 17(1) TESM. Art 1, ESM Guideline on the Primary Market Support Facility (ESM 2012) states that ‘the main objective of the PMSF shall be to allow the ESM Members to maintain or restore their market access.’
ESM is therefore empowered to do, at the ECB’s behest, what the ECB itself is prohibited from doing under Article 123 TFEU.\textsuperscript{1576}

Article 18 TESM: The Secondary Market Support Facility (SMSF) allows for secondary bond purchases with the objective of lowering bond-yields on open markets where the recipient’s economic and financial situation is still essentially ‘sound’.\textsuperscript{1577}

As the ESM does not derive its legal basis from the treaties, the antecedent assumption is that all of these instruments are within the competence of the Member States. Nonetheless, the CJEU has consistently held that Member States are required to exercise their technically exclusive competences in compliance with substantive EU law, and the ESM is no exception.\textsuperscript{1578} The legality of these instruments is therefore governed by Articles 125 and 136(3) TFEU.\textsuperscript{1579}

### 6.1.6 The Outright Monetary Transactions Programme

The OMT was announced in August 2012. It is the latest in a long line of ‘unconventional’ monetary policy instruments.\textsuperscript{1580} The OMT has never been implemented and is embodied in no tangible legal instrument outside of the press release at which it was announced and the September 2012 minutes of the ECB Governing Council at which it was devised.\textsuperscript{1581} The OMT framework consists of ex-ante unlimited secondary bond purchases, subject to compliance with ESM conditionality, with the objective of ‘safeguard[ing] an appropriate monetary policy transmission and the singleness of the monetary policy.’\textsuperscript{1582}

As a monetary policy instrument of the ESCB (not an instrument of public finance governance), the OMT is, in principle, outside the strict scope of this thesis. However, as will be shown, the ESM and OMT are prima facie possessed of the same instrument (secondary bond purchases), pursuant to the same immediate objective (lowering interest-rates through purchases on secondary markets), and are

\textsuperscript{1576} The ESM analysis will ‘recognise the existence of exceptional financial market circumstances and risks to financial stability.’ Arts 17(1) TESM. Art 1, ESM Guideline on the SMSF

\textsuperscript{1577} I.e., the beneficiary must be in compliance with SGP and MIP, have no public debt sustainability problems, no external debt sustainability problems, and an absence of financial institution solvency problems: Arts 1-2 Guideline on the SMSF.


\textsuperscript{1579} As noted above, the ‘no bailout’ rule is still binding, and Article 136(3) TFEU can be no wider than Article 125 as it was drafted at Maastricht. See also: Calleiss (2012), 112. Pringle v Ireland, paras 183-185.

\textsuperscript{1580} Arrie Krampf, 'From the Maastricht Treaty to Post-crisis EMU: The ECB and Germany as Drivers of Change' (2014) 22 Journal of Contemporary European Studies 303.


\textsuperscript{1582} ECB, 'Technical features of OMTs' (2012). The OMT differs from the SMP in three respects: OMT purchases are unlimited (the SMP was limited); OMT claims rank pari passu with private creditors (the ECB refused to participate in a creditor debt cut on its Greek SMP bonds during a February 2012 debt exchange); and the OMT is subject to economic conditionality (SMP purchases were unconditional).
tied to the same economic conditionality (the OMT is predicated on ESM conditionality). Indeed, the only substantive difference between the two would seem to be their effects on monetary policy: The (economic policy) ESM affects inflation, while the (monetary policy) OMT is sterilised, and does not. The ESM and OMT are therefore mirror-images of each other, tracing overlapping issues of competence, and this has direct relevance to the compatibility of the ESM framework with regards to the issue of competence.

Specifically, the mandate of the ECB is limited to the objectives and tasks set out under Articles 119(2) and 127 TFEU, and Articles 2-3 and 17 to 24 of the ESCB Statute.\textsuperscript{1586} In particular, under Articles 127(1) TFEU and Article 2 of the ESCB Statute:

‘The primary objective of the [ESCB] shall be to maintain price stability. Without prejudice to the objective of price stability, [the ESCB] shall support the general economic policies of the Union with a view to contributing to the Achievement of the objectives of the Union as laid down in [Article 3] of the [TEU].’

The ECB may only ‘support’ economic policies that contribute to the establishment of the EMU, and economic policy is a competence which belongs to the Member States.\textsuperscript{1587} As AG Villalón observed in \textit{Gauweiler}, this means that the instruments of the ESCB are essentially limited to control over the monetary base, which do not also have effect of monetary financing.\textsuperscript{1588}

Yet ECB policy documents would seem to be brimming with putative violations of this mandate. The OMT followed-on from 2011 statements by ECB President Draghi that the EFSF/EFSM ‘fell short’ of what was needed to stem interest-rate spreads and called for ‘a new architecture for the euro area.’\textsuperscript{1589} ECB Bulletins in 2011 and 2012 refer to the need for a ‘backstop facility’ with the objective of ‘combating contagion in situations of acute market instability.’\textsuperscript{1590} ECB Executive Jörg Asmussen justified these programs as follows:

\textsuperscript{1586} Under Art 127(2) TFEU, the basic tasks of the ESCB are as follows: To define and implement the monetary policy of the Union, to conduct foreign-exchange operations consistent with the provisions of Article 219, to hold and manage the official foreign reserves of the Member States, and to promote the smooth operation of payment systems. For its tasks, he ECB and ESCB banks may (Art 18.1 ESCB Statute): (i) operate in the financial markets by buying and selling outright (spot and forward) or under repurchase agreement and by lending or borrowing claims and marketable instruments, as well as precious metals; and (ii) conduct credit operations with credit institutions and other market participants, with lending being based on adequate collateral.

\textsuperscript{1587} Tolek Petch, ‘The compatibility of Outright Monetary Transactions with EU law’ (2013) 7 LFMR 13, 14.

\textsuperscript{1588} The test for competence is summarised in \textit{Gauweiler II (Opinion of AG Cruz-Villalón)} [223], as follows: ‘In order for a measure of the ECB actually to form part of monetary policy, it must specifically serve the primary objective of maintaining price stability and it must also take the form of one of the monetary policy instruments expressly provided for in the Treaties and not be contrary to the requirement for fiscal discipline and the principle that there is no shared financial liability.’ See also Weidmann (2013): This requirement [of price stability] is important not least because the instruments of monetary policy are very effective and can be used for purposes other than keeping the value of money stable.’


‘People try to violate principles every day. You have to resist it 99 per cent [of the time] and say, “this is not the extraordinary situation” .... but [this] situation was very different.’

For this reason, the OMT and its predecessor SMP have attracted significant controversy as potential violations of Articles 123 and 127 TFEU, including from German, Dutch, Luxembourg, and French quarters within the ECB’s governing council. Remarkably, the Bundesbank went so far as to testify against the legality the OMT before the BVerfGE in Gauweiler v Bundesbank.

This is not, of course, the legal justification for the OMT. The legal justification is that the objective of ‘safeguarding an appropriate monetary policy transmission and the singleness of the monetary policy’ by neutralising excess risk premiums may be assimilated to the ECB’s competence for price stability proper. The ongoing compatibility of the OMT with Articles 123 and 127 therefore hinges on the assertion that ‘bringing about a fall in - or even the elimination of – excessive risk premia’ - may properly be considered to have ‘price stability’ as its primary objective, and so falls within monetary policy – not economic policy (which the ESM must be).

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1591 Jörg Asmussen, as reported in: Peter Spiegel, “If the euro falls, Europe falls” Financial Times (15 May 2014) <http://www.ft.com/intl/cms/s/0/b4e2e140-d9c3-11e3-920f-00144feabde0.html> accessed 5 March 2015.

1592 See, e.g., Krampf (2014), 307 referring to ‘risk sharing instrument[s] by which the ECB took upon itself the risk from the infected countries… breach[ing] the pre-crisis principle prohibiting the intra-European transfer of risks and resources.’


1594 See: Klaas Knot, President of the Dutch Central Bank, 'Monetary policy and the Great Financial Crisis' (Nyenrode Finance Day, Bruckelen, 28 October 2011): ‘these measures – and the SMP in particular – entailed a number of risks. … to reduce pressure that markets exerted on governments to pursue fiscal discipline… increasing risks of monetary financing of fiscal debt.’

1595 Luxembourg central-banker Mersch (2016): ‘There is no provision for a transfer union in the current Treaty. And whether you like it or not, that applies to the front door as well as the back door.’

1596 Christian Noyer, Banque de France President, 'The Euro Area sovereign debt crisis' (Conférence Banque de France, Toulouse School of Economics, Paris, 19 December 2011): ‘engaging in large-scale asset purchases of sovereign bonds is well beyond what should be expected of a central bank’s role as a [lender of last resort].’

1597 According to Spiegel, the Bundesbank view is that 'The EU treaties are being violated once again.' Editorial, The Bundesbank against the world Der Spiegel (27 August 2012). See also: Spiegel, “If the euro falls, Europe falls” FT (15 May 2014): ‘Many in Berlin saw such ECB action as improper.’

1598 The ECB has defended bond purchases by arguing that they are not aimed at supporting bond prices (though that is the immediate effect), but restoring the monetary policy transmission mechanism by neutralising excess risk premiums (which is in turn assimilated to price stability: See: ECB, 'Technical features of OMT's' (2012); Trichet, ‘The ECB’s response to the recent tensions in financial markets’ (2010); Draghi (2012). See also: Gauweiler II (Opinion of Cruz-Villalón) [121].
6.2 The Pringle v Ireland and Gauweiler v Bundesbank Litigation

*Pringle v Ireland* arose on a preliminary reference from the Supreme Court of Ireland pursuant to a constitutional challenge to the ESM by Irish TD Thomas Pringle.\(^{1599}\) It was the only such case to be referred to the ECJ among number of constitutional challenges to the ESM launched in Austria,\(^{1600}\) Estonia,\(^{1601}\) Slovenia,\(^{1602}\) Germany,\(^{1603}\) Poland\(^{1604}\) and France.\(^{1605}\)

On competence grounds, it was argued, *inter alia*, that Decision 2011/199/EU and the TESM unlawfully infringed on the EU’s monetary and economic competences and therefore breached EU law and the Irish Constitution.\(^{1606}\) This is so because monetary stability is a competence of the union on one side of the ESM (Article 3(1)(c) TFEU), and financial assistance and economic coordination are competences of the Union on the other side (Articles 122(2) and 121/126 TFEU). And yet, *prima facie*, the ESM would appear to engage in both those things.

On substantive grounds, it was argued, *inter alia*, that Decision 2011/199/EU and the TESM entailed ‘a direct and substantive breach on the “no bail-out” principle reflected in Article 125 TFEU’ and the entire framework governing public finance in Articles 119-127 TFEU.\(^{1607}\) The plaintiff argued:

‘The TESM subverts and reverses the “no bail-out” principle. It provides for a permanent “bail-out” scheme that would allow for massive - and... unlimited - borrowing.... This is a most profound change from a “no bail-out” EMU to a “bail-out” EMU.’\(^{1608}\)

Issues pertaining to Irish constitutional law were resolved in the Irish Supreme Court in July 2012. Issues of EU law were referred to the ECJ on the understanding that, if the ESM Treaty were subsequently to be found incompatible with EU law, ‘Ireland - and indeed every Member State - would be required to withdraw from participation and terminate the ESM Treaty.’\(^{1609}\)

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\(^{1599}\) *Pringle v Government of Ireland (Ireland)* [2012] IEHC 296; [2012] 7JIC 1703; *Pringle I (Irish Supreme Court)*.

\(^{1600}\) *ESM (Austria)*.

\(^{1601}\) *ESM (Estonia)*.

\(^{1602}\) See: Huber (2014).

\(^{1603}\) *Re ESM I (Germany); Re ESM II (Germany)*; For comment, see: Susanne Schmidt, ‘A Sense of Déja Vu? The FCC’s Preliminary European Stability Mechanism Verdict’ (2013) 14 German LJ 1; Karsten Schneider, ‘Yes, But... One More Thing: Karlsruhe’s Ruling on the European Stability Mechanism’ (2013) 14 German LJ 53.

\(^{1604}\) *ESM & TSCG (Poland)*.

\(^{1605}\) It was further opposed by political opposition groups in the Czech Republic, Estonia, Germany, Finland, France, and the Netherlands: Huber (2014). Note that not all of these challenges concerned issues of EU law directly. See: ‘V-136(3) TFEU/VIII-TESM: Constitutional Change Through Euro Crisis Law: A Multi-level Legal Analysis’ (*European University Institute*, 2015) <http://eurocrisislaw.eui.eu> accessed 9 April 2016. See also: Beukers and De Witte (2013), 816; Bardutzky and Fahey (2014) (discussing challenges in Ireland, Estonia, Germany, Austria, Finland and the UK).


\(^{1607}\) ‘Written Observations of Thomas Pringle in Case C-370/12 Pringle v Ireland’ (2012), 28-34 [3.49].

\(^{1608}\) ‘Written Observations of Thomas Pringle in Case C-370/12 Pringle v Ireland’ (2012), 18.

\(^{1609}\) ‘Written Observations of Thomas Pringle in Case C-370/12 Pringle v Ireland’ (2012).
Gauweiler v Bundesbank, launched shortly after Pringle, concerned a challenge to the ESM’s monetary counterpart, the OMT, under EU and German constitutional law. The OMT has been the subject to litigation before the CJEU (initiated by 5,217 applicants) and the BVerfGE (initiated by 11,000 applicants) since 2012. The Gauweiler v Bundesbank litigation has three instalments: Gauweiler I - an assertive January 2014 reference from the BVerfGE arguing that the OMT exceeded the ECB’s by engaging in economic policy, Gauweiler II - a June 2015 preliminary ruling by the ECJ concluding that the ECB did not exceed its competences, and Gauweiler III - the June 2016 ruling of the BVerfGE which put an end to the OMT litigation by concluding, for the second time, that the OMT did exceed the competences of the ECB, but that the breach would not be ‘manifest’ in so far as it complied with six restrictions on its operation. The BVerfGE then devised the remarkable remedy of placing the Bundesbank and Bundestag in a position of monitoring compliance with the conditions set out by the court, resulting in the curious situation of instructing national institutions to effectively ‘blow the whistle’ on an act of (technically supreme) EU law.

Pringle v Ireland and Gauweiler v Bundesbank therefore trace overlapping issues of EU law, and this analysis examines them together when investigating the issue of competence.

6.3 Conformity with the Allocation of Competences

Taking the ESM first, the issue of competence arises with regard to both of the ESM’s constitutive instruments: Decision 2011/199/EU (amending Article 136 TFEU) and the TESM itself. The challenge to Decision 2011/199/EU arises as a consequence of the simplified procedure by which it was enacted. The simplified procedure under Article 48(6) TFEU allows the European Council to amend all or part of the provisions of Part Three of the Treaty by unanimity, subject to two conditions:

(i) The procedure may only be used to amend the provisions of Part Three of the TFEU; and

(ii) The procedure may not be used to increase the competences conferred on the Union.

Monetary policy and economic coordination, however, are both competences of the Union under Articles 2(3), 3(1)(c) and 5(1) TFEU - provisions in Part One of the Treaty. An amendment which gave the Member States a power in monetary policy (e.g. secondary bond purchases under the

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1610 Gauweiler I (Germany).
1611 Von Storch I; Von Storch II.
1612 Gauweiler I (Germany); Gauweiler II (Opinion of AG Cruz-Villalón); Gauweiler II (CJEU) Gauweiler III (Germany).
1613 Gauweiler I (Germany).
1614 Gauweiler II (Opinion of AG Cruz-Villalón); Gauweiler II (CJEU) Gauweiler III (Germany).
1615 Gauweiler III (Germany). The six conditions are: (1) Purchases must not be announced, (2) the volume of purchases must be limited from the outset, (3) a minimum period must be observed between the issuance of government bonds and their purchase by the ESCB that is defined from the outset and prevents the issuing conditions from being distorted, (4) the ESCB purchases only government bonds of Member State that have bond market access, (5) purchases bonds are only held to maturity in exceptional cases, and (6) purchases are restricted or ceased and purchased bonds are remarshaled should continuing intervention become unnecessary.
OMT), or gave the Union a new power in economic policy (i.e., by dictating economic policy to governments) would violate both of these conditions.\textsuperscript{1616}

The same issues arise in relation to the TESM itself because, under Articles 2(1) and (2) TFEU, Member States may not adopt legally binding acts in areas of exclusive union competence, and may act in shared competences only ‘to the extent that the Union has not exercised its competence.’ Yet monetary policy,\textsuperscript{1617} financial assistance,\textsuperscript{1618} and economic coordination\textsuperscript{1619} are all competences of the Union under the Treaties. \textit{Prima facie}, the ESM would seem to do all these things: It conducts secondary bond purchases to ‘address severe distortions in government bond markets and provide a fully effective backstop’ – an instrument which the ECB has in the OMT;\textsuperscript{1620} it provides financial assistance to Member States in distress - a competence with the Union has under Article 122(2) TFEU) and the EFSM; and it negotiates economic conditionality – the terms of which are then enacted under the Union’s ‘coordination’ competence in Articles 121 and 126 TFEU.\textsuperscript{1621}

To take account of the overlapping issues of competence between the ESM and the OMT, this analysis merges these decisions into a single procedure devolved into four cumulative assessments:

[6.3.1] Whether ‘safeguarding the stability of the monetary union’ properly belongs to the (Union) competence for monetary policy or the (national) competences for economic policy. If monetary policy, then the TESM must, by necessity, be \textit{ultra vires} Member State competence and Decision 2011/199/EU must violate Article 48(6) TEU by amending the Union’s monetary competence in Article 3(1)(c) TFEU. If economic policy, then the OMT must, by necessity, be \textit{ultra vires} the Union competence in monetary policy. If they can both somehow be reconciled to their respective constitutional corners, then:

[6.3.2] As the Union has enacted its own financial assistance mechanism under Article 122(2) TFEU, whether that Union competence is an exclusive or shared competence. If exclusive, the TESM must be \textit{ultra vires} Member State competence under Article 2(1) TFEU, and Decision 2011/199/EU must violate Article 48(6) TEU by amending the Union’s competences in Articles 2(3) and 5(1) TFEU. If shared, Decision 2011/199/EU may survive but the ESM is preempted by the Union’s activation of the EFSM. If financial assistance is not an EU competence at all, then:

\textsuperscript{1616}On the development and use of Art 48(6) TEU, see: De Witte, ‘The European Treaty Amendment’ (2011).
\textsuperscript{1617}Art 3(1)(c) TFEU.
\textsuperscript{1618}Articles 122(2), 143 TFEU.
\textsuperscript{1619}Articles 2(3), 5(1) TFEU.
\textsuperscript{1620}Articles 119(2) and 127 TFEU, and Articles 2-3 and 17 to 24 of the ESCB Statute. See, e.g., ECB, ‘Monthly Bulletin September 2012’ (2012), 7: ‘OMTs will enable the Eurosystem to address severe distortions in government bond markets... [and] provide a fully effective backstop to avoid destructive scenarios...’
\textsuperscript{1621}E.g., Art 7 Reg 472/2013 states: ‘Full consistency between the Union multilateral surveillance framework established by the TFEU and the possible policy conditions attached to financial assistance should be enshrined in EU law.’
[6.3.3] Whether ESM conditionality trespasses upon the Union’s economic ‘coordination’ competence or falls within Member State economic policy proper. If the former, the TESM is *ultra vires* Member State competence, and Decision 2011/199/EU must violate Article 48(6) TEU by amending the Union’s competence in Articles 2(3) and 5(1) TFEU. If the latter, then:

[6.3.4] Whether the involvement of EU institutions in the ESM involves them in economic policy. If so, then Decision 2011/199/EU violates Article 48(6) TEU by extending the competences of the Union, and the TESM violates the requirement in Article 13(2) TEU for the EU institutions to act only ‘within the limits of the powers conferred [in] the Treaties.’

The apparent difficulties in meeting these criteria should be noted at the outset. Any averse finding on any one of these successive questions will necessarily render the ESM unlawful. Taken cumulatively, a positive finding of legality requires the ESM to reconcile several apparently disjunctive criteria:

[6.3.1] On one hand, secondary bond purchases for the stability of the monetary union under the ESM must fall decisively within economic policy; on the other hand, secondary bond purchases for the stability of the monetary union under the OMT must fall decisively within monetary policy.

[6.3.2] On one hand, the ESM must not intrude upon the competences of the EFSM for financial assistance; on the other hand, the ESM must be permitted to directly subsume EFSM financial assistance.

[6.3.3] One hand, the objectives and operation of the ESM must fall decisively outside the scope of EU law; on the other hand, the EU institutions and acts binding throughout its operation must not be doing anything outside the scope of EU law.

[6.3.4] On one hand, the Member States can have no power to coordinate economic policy; on the other hand, ESM conditionality negotiated on behalf of the Member States is enacted into binding EU law under Regulation 472/2013.

If the ESM is genuinely reconcilable with the fault lines running through the Treaties, it must be clear that it is not based upon an ‘accumulation of contradictions with and circumventions of the Union legal order.’

Any such irregularities will signal that the ESM does not fit within the allocation of economic competences which mark the border with the fiscal sovereignty of the Member States.

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1622 Tomkin (2013), 187; Borger (2013), 127.
6.3.1 Monetary Policy vs Economic Policy

6.3.1.1 Pringle v Ireland

Under Articles 136(3) TFEU and 3 TESM, the purpose of the ESM is to ‘safeguard the stability of the euro area as a whole.’ Yet this sounds suspiciously like monetary policy - the exclusive competence of the Union. To that end, the plaintiff in Pringle argued that ‘the fundamental and defining purpose of the ESM is rooted in Union monetary policy,’ and would have a ‘direct impact’ on inflation and price stability in the euro area.

In Pringle v Ireland, the ECJ rejected this argument and concluded that the ESM fell wholly within the province of economic policy. This conclusion was reached by adopting an objectives-based approach: The objective of the ESM, namely, ‘the financial stability of the euro area as a whole’ (economic policy), was seen as distinct from from ‘price stability’ (monetary policy). The Court concluded:

‘As regards, first, the objective pursued by that mechanism, which is to safeguard the stability of the euro area as a whole, that is clearly distinct from the objective of maintaining price stability, which is the primary objective of the Union’s monetary policy. [...] The grant of financial assistance to a Member State... clearly does not fall within monetary policy.

Under arts 3 and 12(1) of the TESM, it is not the purpose of the ESM to maintain price stability, but rather to meet the financing requirements of ESM Members … if indispensable to safeguard the financial stability of the euro area as a whole and of its Member States. To that end, the ESM is not entitled either to set the key interest rates for the euro area or to issue euro currency. [...]’

Even if the activities of the ESM might influence the rate of inflation, such an influence would constitute only the indirect consequence of the economic policy measures adopted.

6.3.1.2 Gauweiler v Bundesbank I-II

In Gauweiler v Bundesbank I, the BVerfGE applied Pringle verbatim to the OMT, ruling that since ESM secondary bond purchases to ‘support the good functioning of the government debt markets

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1623 Art 136(3) TFEU states that the Member States may establish a stability mechanism to be activated if indispensable 'to safeguard the stability of the euro area as a whole.' Art 3 of the TESM states that the purpose of the ESM is 'to safeguard the financial stability of the euro area as a whole and of its Member States.'

1624 Outside of Article 136(3), the Treaties employ the term 'stability' exclusively in the context of the 'price stability.' See: Art 3(3)(1) TFEU; Arts 119(2)-(3), 127(1), and 282(2)TFEU; Art 2(1) Statute of the ECB. Cf: Arts 14, 17-18 TESM.


1626 Pringle v Ireland, stated: 'Under arts 127(1) TFEU and 282(2) TFEU, the primary objective of the Union’s monetary policy is to maintain price stability... It is necessary therefore to examine whether or not the objectives to be attained by the [ESM] fall within monetary policy for the purposes of arts 3(1)(c) and 127 TFEU.' Decision 2011/199/EU is addressed at [52]-[63]; the TESM is addressed at [93]-[98].

1627 Pringle v Ireland [53]-[57], [96]-[97] [emphasis added] adding that the objective of the ESM is: the 'management of financial crises which, notwithstanding such preventative action as might be taken, might nonetheless arise.'
where the lack of market liquidity threatens financial stability’ is economic policy per Pringle, then so also must be the OMT programme.\textsuperscript{1628} The BVerfGE observed that, like the ESM, the immediate objective of the OMT was to ‘neutralise spreads on government bonds of selected Member States of the euro currency area which have emerged in the markets and which adversely affect the refinancing of these Member States.’\textsuperscript{1629} Although this might subsequently or indirectly influence the rate of inflation – per Pringle - ‘such an influence would constitute only the indirect consequence of the economic policy measures adopted.’\textsuperscript{1630} To belabour the point, the BVerfGE quoted extensively from the portions of Pringle where – in order to save the ESM from a violation of competence – the ECJ held that secondary bond purchases with the objective of ‘safeguarding the stability of the euro area’ ‘clearly’ is not price stability, and that financial assistance ‘clearly’ does not fall within monetary policy.\textsuperscript{1631} The BVerfGE alleged a ‘manifest breach’ under the ultra vires test and an infringement of fiscal sovereignty.\textsuperscript{1632}

In the preliminary ruling which followed, the ECJ rejected this argument and upheld the OMT. According to the ECJ, the objective of the OMT was not to ‘support the good functioning of the government debt markets where the lack of market liquidity threatens financial stability’ (the ESM) but to safeguard ‘an appropriate monetary policy transmission and the singleness of the monetary policy’ (the OMT).\textsuperscript{1633} This was then classified as a monetary policy objective because, under Article 119(2) TFEU, monetary policy must be ‘single’ and monetary transmission could, in turn, be assimilated to the objective of price stability. The court explained:

‘First the objective of safeguarding the singleness of monetary policy contributes to achieving the objectives of that policy in as much as, under Article 119(2) TFEU, monetary policy must be ‘single’.

Secondly, the objective of safeguarding an appropriate transmission of monetary policy is likely both to preserve the singleness of monetary and to contribute to its primary objective which is to maintain price stability.’\textsuperscript{1634}

It should be emphasised here that the court brings these effects under the competence for price stability by noting that their achievement ‘contributes’ to price stability. As explained by ECB

\textsuperscript{1628} Gauweiler I (Germany) at [55], [70]. Cf: Art 1 ESM Guideline on the SMSF.

\textsuperscript{1629} Gauweiler I (Germany) at [55], [70].

\textsuperscript{1630} Pringle v Ireland [56], [96]-[97].

\textsuperscript{1631} Gauweiler I (Germany) at [65] [emphasis added]. Cf: Pringle v Ireland [56]-[57].

\textsuperscript{1632} Gauweiler I (Germany) at [39]-[40] ‘If the [ECB] exceeded its monetary policy mandate with the OMT Decision, it would thus interfere with the responsibility of the Member States for economic policy. According to Title VIII of the [TFEU] … the responsibility for economic policy lies clearly with the Member States… [The ECB] is not authorised to pursue its own economic policy. If one assumes [that] the OMT Decision is to be qualified as an independent act of economic policy, it manifestly violates this distribution of powers.’ See also: Gauweiler II (CJEU), AG Villalón, [55].

\textsuperscript{1633} Gauweiler II (CJEU) [47].

\textsuperscript{1634} Gauweiler II (CJEU) [48]-[50] (emphasis added).
Executive Asmussen in his testimony to the BVerfGE, ‘a currency can only be stable if its continued existence is not in doubt.’

First, the ECJ recognises that bond-purchases under the OMT have, as their immediate objective, lowering interest rates on specific bonds: ‘[T]he purchase, on secondary markets, of government bonds of the Member States affected by interest rates considered by the ECB to be excessive is likely to contribute to reducing those rates … and thus to play a part in bringing about a fall in - or even the elimination of - excessive risk premia.’

Second, the ECJ recognises that unblocking transmission mechanisms are a likely (though not certain) consequences of this objective: ‘Therefore, eliminating or reducing the excessive risk premia demanded in respect of the government bonds of a Member State is likely to avoid the volatility and level of those premia from hindering the transmission of the effects of the ESCB’s monetary policy … [and] the singleness of monetary policy.’

Third, and finally, these effects are ‘likely’ to ‘contribute’ to the achievement of price stability: ‘The objective of safeguarding an appropriate transmission of monetary policy is likely both to preserve the singleness of monetary policy and to contribute to its primary objective, which is to maintain price stability.’

Price stability, in fact, only arises as a tertiary (twice removed) possible and partial indirect consequence from the initial object of lowering interest rates. Indeed, the BVerfGE, the ECJ, and the Advocate General all clearly enunciate a distinction between two objectives, ‘the first direct or immediate and the other indirect.’ The immediate objective is to lower interest rates; the indirect consequence of that is to unblock transmission channels, and, the indirect consequence of that is to ‘contribute to’ the ECB’s ability to ensure price stability at some point in future. The immediate objective is to lower interest rates, and price stability arises neither as a direct or certain outcome of that immediate object.

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1636 Gauweiler II (CJEU) [76].
1637 Gauweiler II (CJEU) [58] (emphasis added).
1638 Gauweiler II (CJEU) [49], [58].
1639 Gauweiler I (Germany) at [55], [70].
1640 According to the ECB, ‘OMTs [1] will enable the Eurosystem to address severe distortions in government bond markets [and] provide a fully effective backstop to avoid destructive scenarios with potentially severe challenges for price stability… [2] ensuring an effective transmission of the Eurosystem’s monetary policy and thereby, at securing the conditions for an effective conduct of the single monetary policy within the euro area, [3] with a view to achieving its primary objective of maintaining price stability.’ (Numbers added) ECB, ECB Monthly Bulletin October 2012 (2012), 7.
1641 Gauweiler II (CJEU) [49], [58].
1642 Gauweiler II (Opinion of AG Cruz-Villalón) [136] ‘In the first place, the direct objective is to reduce the interest rates demanded for a Member State’s government bonds in order, subsequently [in the second place], to “normalise” the interest rate differentials and thus restore the ECB’s monetary policy instruments.’
6.3.1.3 Analysis

The use of an objectives-based approach to classifying monetary policy would appear necessary in principle. As noted by AG Kokott, the interrelationship between economic and monetary policy is so extensive that to define them solely on an effects-based approach would preclude the entire arrangement of economic competences under the Treaty.\(^{1643}\) Where criticisms remain apt, however, is in the application of that test.

In *Pringle v Ireland*, the ECJ classified the ESM’s instruments as having the following purpose: [1] ‘to meet the financing requirements of ESM Members,’\(^{1644}\) in order [2] ‘to safeguard the financial stability of the euro area.’\(^{1645}\) Thereafter [3] tertiary (twice-removed) ‘effects on the inflation level’ could be discounted as ‘only the indirect consequence of the economic policy measures adopted.’\(^{1646}\) According to *Pringle*, indirect effects must be disregarded.

In *Gauweiler v Bundesbank*, the ECJ appeared to apply this test in reverse: The OMT has the purpose of [1] ‘the reduction of the financing costs of the State concerned,’\(^{1647}\) in order to [2] repair the ‘transmission of monetary policy decisions to the economy and the singleness of monetary policy.’\(^{1648}\) Thereafter, [3], as a tertiary (twice removed) effect, this ‘*contribut[es] to the ESC’s objectives and, therefore, to maintaining price stability.*’\(^{1649}\) Price stability itself does not even arise at all in this chain of causality at all – it is only [4] a possible consequence to be taken up in future.\(^{1650}\) This is *Pringle*, turned inside-out. Financial assistance comes long before price stability in

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\(^{1643}\) See, *Pringle v Ireland (View of AG Kokott)* [85], ‘the entire economic policy would be reserved to the ESCB and the rules of the Treaty on the coordination of economic policy within the Union would be devoid of meaning.’ Cf: Craig, *Pringle* (2013) 5 (‘In economic terms, the stability of the euro area as a whole is surely a condition precedent to price stability within that area’); Beck (2014), 241 (What seems implausible is that a measure expressly designed to stabilise the currency has nothing to do, and is not primarily concerned, with monetary policy); Steve Peers, *The Future of EU Treaty Amendments* (2012) 31 YB Eur L 7, 22 (‘it would not be possible to use Article 48(6) to adopt an amendment which nominally placed in Part Three TFEU but which de facto amends other primary law provisions’).

\(^{1644}\) *Pringle v Ireland* [96]-[97].

\(^{1645}\) *Pringle v Ireland* [96]-[97].

\(^{1646}\) *Pringle v Ireland* [96]-[97].

\(^{1647}\) *Gauweiler II (CJEU)* [76].

\(^{1648}\) *Gauweiler II (CJEU)* [58] (emphasis added).

\(^{1649}\) *Gauweiler II (CJEU)* [80].

\(^{1650}\) As stated in *Gauweiler II (Opinion of AG Cruz-Villalón)* [136].
the chain of causality. Citing *Pringle v Ireland* verbatim, this was the point made by the BVerfGE:

‘The fact that the purchase of government bonds can, under certain conditions, help to support the monetary policy objectives of the [ESCB] does not turn the OMT Decision itself into an act of monetary policy.’

The Objectives-Based Test in *Gauweiler v Bundesbank*

This is not the only problem. Accepting, for the moment, that the objectives selected from the chain of causality are true accounts of what those instruments ‘do,’ it nonetheless cannot be avoided: the OMT and ESM rely upon the *exact same* instrument, for the *exact same* purpose, pursuant to the *exact same* objective, subject to the *exact same* economic conditionality.

First, the objective of the ESM’s SMSF is ‘to support the good functioning of the government debt markets where the lack of market liquidity threatens financial stability.’ In order to be lawful, this must be economic policy. The objective of the ECB’s OMT, however, is ‘to ensure depth and liquidity in those market segments which are dysfunctional.’ In order to be lawful, this must be monetary policy. Yet they both accomplish the *exact same* objective. Indeed, it is quite remarkable that the ECB uses precisely the same arguments to justify the OMT that it had used before the BVerfGE in past cases to argue that the ESM was economic policy and *not* ECB competence. In *Re ESM (Germany)*, for example, the ECB argued that:

1651 Applying the legal test of criminal intent, Petch (2013), 18 points out that if the ECB intends to bring about uncertain result [4] (price stability) but this ‘necessarily and inevitably’ entails result [1] (reduce bond premiums) as a precondition to [4], then while [4] may be accepted as a motive… the ECB intends to reduce government borrowing costs.’

1652 *Gauweiler I (Germany)* at [96].


1654 Art 1 ESM Guideline on the SMSF.


1656 ECB Bulletins (see e.g. *ECB Monthly Bulletin October 2012* (2012)) cited by the BVerfGE explicitly state that the concern of the OMT is stopping ‘financial market fragmentation’ and ‘addressing severe distortions in government bond markets by providing a fully effective backstop to avoid destructive scenarios.’

1657 In *Aid Measures for Greece (Germany)* [90], the ECB argued that financial stability was economic policy: ‘The latest developments… on the government bond markets had the potential to considerably increase the total risk to the financial stability of the euro area, and it should be noted that financial stability is a basic condition of the guarantee of price stability.’ The BVerfGE relied on similar arguments to hold that the ESM ‘uses the funds at its disposal for direct financial stabilisation of its members, which the [ECB] is prevented from doing by art.123 TFEU’ in *Re ESM I (Germany)* [246].
‘In a monetary union based on stability… it is a central duty of financial policy [Member State competence] to ensure that sound state finances and a suitable framework appropriately support monetary policy.’

Indeed, both the German and European courts recognise the same primary objective for the OMT. According to the BVerfGE: ‘the primary objective of the purchases is the reduction of the interest rates the Member States that benefit have to pay on the capital markets for new government bonds.’ Accordingly to the ECJ: ‘the central objective of the OMT programme is to stabilise the interest rates applicable to certain government bonds … [and] the immediate objective is the reduction of the financing costs of the State concerned.’

Beck concludes:

‘it is therefore difficult to comprehend how measures adopted by the Member States, which share the same objective as the ECB’s policies…. should be construed as falling exclusively within a different area of competence, namely economic policy, when the same measure must be regarded as part of monetary policy when resorted to by the ECB.’

Second, the instruments themselves are identical. The ESM employs the SMSF in Article 18 of the TESM, the stated objective of which is to reduce sovereign bond yields and improve the financing conditions of the state. The OMT employs secondary bond purchases under Article 18 of the ESCB statute, the stated objective of which is to reduce sovereign bond yields and improve the refinancing conditions of the state. They are the exact same instrument.

Third, in order to differentiate this outcome, the ECJ argues that the instruments are different because triggers for the ESM and OMT are different: the OMT is triggered by the need to ‘safeguard monetary policy transmission and the singleness of monetary policy’ and so retains its own criteria as to whether secondary bond purchases are warranted ‘from a monetary policy objective.’

But this makes little sense. Is there any qualitative difference between restoring the ‘interest-rate transmission mechanism and the singleness of monetary policy,’ (the OMT) and ‘to support the good

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1658 Aida Measures for Greece (Germany) [90] [emphasis added].
1659 Gauweiler I (Germany) at [55].
1660 Gauweiler II (CJEU) [240] (emphasis added).
1661 Beck (2014), 242 [emphasis added].
1662 Jürgen Bast, ‘Don’t Act Beyond Your Powers: The Perils and Pitfalls of the German Constitutional Court’s Ultra Vires Review’ (2014) 15 German LJ 167, 176. See also Beukers and De Witte (2013), 831: the ECJ fails to ‘explain how the activities of the ESM - providing credit facilities to Member States - are different also from [open market and credit operations]’ under Article 18(1) of the ESCB Statute.
1663 Art 1 ESM Guideline on the SMSF states: ‘The Secondary Market Support Facility, in accordance with article 18 of the ESM Treaty, aims to support the good functioning of the government debt markets of ESM Members in exceptional circumstances where the lack of market liquidity threatens financial stability, with a risk of pushing sovereign interest rates towards unsustainable levels and creating refinancing problems for the banking system of the ESM Member concerned. An ESM secondary market intervention is intended to enable market making that would ensure some debt market liquidity and incentivise investors to further participate in the financing of ESM Members.’
1664 ECB Monthly Bulletin October 2012 (2012) states that the objective of the OMT is stopping ‘financial market fragmentation’ and ‘addressing severe distortions in government bond markets by providing a fully effective backstop.’
functioning of the government debt markets of ESM Members in exceptional circumstances where
the lack of market liquidity threatens financial stability’ in order to ‘safeguard the stability of the
euro area as a whole’ (the ESM)?\textsuperscript{1666} The court does not say. It seems impossible, however. The
OMT is triggered when the singleness and transmission of monetary policy is threatened by rising
default risk, and default risk only arises due to the prospect of default. Since any Member State
default would end the ‘singleness of monetary policy’ and the ‘stability of the euro area’ in equal
measure, this amounts to a permanent guarantee that the ECB will provide a permanent guarantee
against default once interest-rates hit a specific ceiling.\textsuperscript{1667} Buiter and Grafe explain:

‘If the ECB attaches value to the prevention of sovereign default (or to the mitigation of the
consequences of a sovereign default), the markets will anticipate that, at some point … the
ECB will monetise some or all of the public debt issued by a fiscally lax national authority. It
is as if the ECB implicitly guarantees the public debt of the national authorities.’\textsuperscript{1668}

ECB President Draghi exemplifies this perfectly, admitting that while the OMT had no specific
‘trigger’ beyond a general ‘sense of worsening of the crisis’ - ‘certainly one thing … was the sudden
increase in the shorter part of the yield curve for several countries in the euro area [and] other
symptoms of market fragmentation.’\textsuperscript{1669}

Yet it must be recalled that the ECB has no competence for economic policy. As Bundesbank
President Weidmann so puts it: ‘The central bank is responsible for monetary stability, while
national and European politicians decide on the composition of the monetary union. It wasn’t the
central banks that decided which countries are allowed to join the monetary union.’\textsuperscript{1670} For this
reason, in Gauweiler III, the BVerfGE rejected this justification out of court, stating:

‘As for the European Central Bank claiming to safeguard the current composition of the euro
currency area […] this is obviously not a task of monetary policy but one of economic policy,
which remains a responsibility of the Member States.’\textsuperscript{1671}

\textsuperscript{1666} Art 1 ESM Guideline on the SMSF
\textsuperscript{1667} Empirical evidence shows, for example, that markets will penalise a government with high debt who runs a deficit, but will be more forgiving of the same deficit if the government has low debt. The difference between the two is the risk of default: Sutherland, Price and Joumard (2005), 36; Tamim Bayoumi, Morris Goldstein and Geoffrey Woglom, 'Do Credit Markets Discipline Sovereign Borrowers? Evidence from US States' (1995) 27 J Money Credit Bank 1046; Alberto Alesina and others, 'Default risk on government debt in OECD Countries' (1992) 7 Econ Policy 427; Silvia Ardagna, Francesco Caselli and Timothy Lane, 'Fiscal Discipline and the Cost of Public Debt Service: Some Estimates for OECD Countries' (2004) No 411 ECB Working Paper Series Fiscal Discipline; Balassone, Franco and Giordano (2004), 410.
\textsuperscript{1669} Draghi and Constancio (2012).
\textsuperscript{1670} Editorial, 'Bundesbank President on ECB Bond Purchases: Too Close to State Financing Via the Money Press' (2012).
\textsuperscript{1671} Gauweiler III (Germany) [72].
For the purposes of this thesis, this must be decisive. It is defensible to conclude that the ESM is an act of economic policy on the objectives-based test, but the Union cannot have it both ways. The ESM’s SMSF and the ECB’s OMT constitute the *exact same* instrument (secondary bond purchases) with the *exact same* purpose (‘the reduction of the financing costs of the State concerned’),\textsuperscript{1672} pursuant to the *exact same* objective: ‘to support the good functioning of the government debt markets of ESM Members in exceptional circumstances where the lack of market liquidity threatens financial stability’ (ESM),\textsuperscript{1673} or ‘to ensure depth and liquidity in those market segments which are dysfunctional’ (OMT).\textsuperscript{1674} Both also activate upon the exact same trigger: A financial threat to the political composition of EMU. Whatever test is used, it is impossible to conclude that both instruments are separately, implicitly and simultaneously countenanced by the allocation of competences in the Treaty.

The proof for this proposition as a matter of law is set out in the final ruling of the BVerfGE in *Gauweiler v Bundesbank (III)*, in which the BVerfGE inveighed against the ruling of the ECJ and concluded that it failed to ‘completely remove the character of the OMT programme insofar as it encroaches upon economic policy.’ It held:

‘[T]he judgment of 16 June 2015 meets with serious objections on the part of the [BVerfGE]. These objections concern the way the facts of the case were established, the way the principle of conferral was discussed, and the way that the judicial review of acts of the [ECB] that relate to the definition of its mandate was conducted.

Firstly, the [ECJ] accepts the assertion that the OMT programme pursues a monetary policy objective without questioning or at least discussing and individually reviewing the soundness of the underlying factual assumptions, and without testing these assumptions with regard to the indications that evidently argue against a character of monetary policy.

Furthermore – despite its own belief that economic and monetary policy overlap – the [ECJ] essentially relies on the objectives of the measure as indicated by the organ on review as well as on the recourse to the instrument of the purchase of government bonds in Art. 18 of the ESCB Statute when qualifying the OMT programme as an instrument belonging to the field of monetary policy.’\textsuperscript{1675}

In the final result, the BVerfGE ruled that the OMT did, in fact, breach the allocation of competences in the Treaty. However, subject to six conditions placed on its operation, this breach was not ‘manifest’ and ‘structurally significant’ according to the *Honeywell (Germany)* test and did not

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\textsuperscript{1672} *Gauweiler II (CJEU)* [240] (emphasis added).

\textsuperscript{1673} Art 1, ESM Guideline on the SMSF.

\textsuperscript{1674} Trichet, ‘The ECB’s response to the recent tensions’ (2010); ECB, ‘Technical features of OMTs’ (2012).

\textsuperscript{1675} *Gauweiler III (Germany)* [3](b).
'present a constitutionally-relevant threat to the Bundestag’s right to decide on the budget under the 'constitutional identity’ test set out in Sections 1.3.1.3-1.3.1.6 of this thesis.'\textsuperscript{1676}

The constitutional significance of this decision should not be understated, however. Although the breach was not ‘manifest’, the BVerfGE has ruled that the OMT does exceed the constitutional boundaries in this thesis. Importantly, the BVerfGE has not only placed six restrictions on the operation of a (technically) supreme act EU law, but placed the Bundesbank and the Bundestag in a position of supervision over the ECB:

‘[D]ue to their responsibility with respect to European integration (Integrationsverantwortung), the Federal Government and the Bundestag are under a duty to closely monitor any implementation of the OMT programme. This compulsory monitoring shall determine not only whether the abovementioned conditions are met, but also whether there is a specific threat to the federal budget – deriving in particular from the volume and the risk structure of the purchased bonds, which may change even after their purchase.’\textsuperscript{1677}

In line with the hypothesis of this chapter, the architecture of conditional financial assistance has, as a matter of law, violated the constitutional boundaries of this thesis such that the application of this mechanism is now subject to the continuous acquiescence and supervision set by national constitutional organs. According to the BVerfGE, the German Bundesbank ‘may only participate in the programme’s implementation if and to the extent that’ the prerequisites set out by the court are met.\textsuperscript{1678} Indeed, as predicted in Chapter 1, the BVerfGE explicitly states that the ECJ’s interpretation ‘is acceptable’ only because it ‘essentially performed the restrictive interpretation’ set out in the BVerfGE’s order for reference.\textsuperscript{1679}

6.3.2 Encroachment on the Union Competence for Financial Assistance

6.3.2.1 Pringle v Ireland

The conclusion that ESM financial assistance is not monetary policy leads to a subsequent problem. Financial assistance is a competence conferred on the Union under Article 122(2) TFEU, and it is a mechanism enacted under that article – the EFSM - which the ESM was designed to replace. As the Plaintiff in Pringle argued:

\textsuperscript{1676} Gauweiler III (Germany) [3](a)-(f). The six conditions are: Purchases are not announced; the volume of the purchases is limited from the outset; there is a minimum period between the issue of the government bonds and their purchase by the ESCB that is defined from the outset and prevents the issuing conditions from being distorted; the ESCB purchases only government bonds of member States that have bond market access enabling the funding of such bonds; purchased bonds are only in exceptional cases held until maturity; and purchases are restricted or ceased and purchased bonds are remarshaled should continuing the intervention become unnecessary.

\textsuperscript{1677} Gauweiler III (Germany).

\textsuperscript{1678} Gauweiler III (Germany) [3](e) [emphasis added].

\textsuperscript{1679} Gauweiler III (Germany) [3](c): ‘Although – unlike the Senate – the Court of Justice does not question the indicated objectives and evaluates each of the signs that the Senate holds to argue against the alleged objectives … this is acceptable because on the level of the exercise of competences the Court of Justice has essentially performed the restrictive interpretation of the policy decision that the Senate’s request for a preliminary ruling of 14 January 2014 held to be possible.’
Recital (1) of the TESM provides that the ESM will assume the tasks currently fulfilled by the EFSF and the EFSM. In so doing, it is clearly envisaged that the ESM should exercise a competence which has been both conferred on and exercised by the Union.\textsuperscript{1680}

In \textit{Pringle v Ireland}, the ECJ avoided this outcome by holding that Union financial assistance (Article 122(2) TFEU) and Member State financial assistance (Article 136(3) TFEU) occupy two distinct fields of competence.\textsuperscript{1681} The court explained:

‘Admittedly, art.122(2) TFEU confers on the Union the power to grant \textit{ad hoc} financial assistance to a Member State which is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control. However... art.122(2) TFEU does not constitute an appropriate legal basis for the establishment of a stability mechanism of the kind envisaged by that decision. The fact that the mechanism envisaged is to be permanent and that its objectives are to safeguard the financial stability of the euro area as a whole means that such action cannot be taken by the Union on the basis of that provision of the FEU Treaty.'\textsuperscript{1682}

\textbf{6.3.2.2 Analysis}

By this passage, the ECJ conceives of two separate fields of competence: The EFSM occupies the field of \textit{ad hoc} financial assistance to a Member State which is in difficulties caused by exceptional occurrences beyond its control (122(2) TFEU); and the ESM occupies the field of permanent financial assistance designed to safeguard the financial stability as a euro area as a whole (136(3) TFEU).\textsuperscript{1683} The court divides these fields by three distinguishing characteristics:

(i) Their tasks: The ESM has the task of providing financial assistance, whereas, ‘Since arts 2(3) and 5(1) TFEU restrict the role of the Union in the area of economic policy to the adoption of co-ordinating measures’ the Treaties do not confer any specific power on the Union to establish a stability mechanism of that kind.\textsuperscript{1684}

(ii) Their objectives and criteria: The EFSM is activated in the event of difficulties caused by exceptional occurrences beyond Member State control, while the ESM is activated in the event of instability to the euro area as a whole.\textsuperscript{1685}

(iii) Their duration: The EFSM is ‘ad-hoc’ and the ESM is ‘permanent.’\textsuperscript{1686}

\textsuperscript{1680} ‘Written Observations of Thomas Pringle in Case C-370/12 Pringle v Ireland’ (2012), 25

\textsuperscript{1681} Pringle v Ireland [67]-[68], [105], [120]. As explained in Pringle v Ireland (View of AG Kokott) [125], ‘measures taken by the Union and measures taken by the Member State are in different contexts.’

\textsuperscript{1682} Pringle v Ireland [65].

\textsuperscript{1683} Pringle v Ireland [65].

\textsuperscript{1684} See, e.g., Pringle v Ireland [64]-[65], [104]-[105].

\textsuperscript{1685} See, e.g., Pringle v Ireland [104]-[105].

\textsuperscript{1686} See, e.g., Pringle v Ireland [104]-[105].
However, the distinguishing characteristics which the court has chosen to divide the mechanisms into separate competences are simply incapable of discrete application. On any ostensible application of these criteria, both mechanisms must occupy the same field.

First, the ESM is held not to overlap with the Union competence in economic policy because, according to the court, the Union competence in economic policy is limited ‘to the adoption of coordinating measures’.\(^{1687}\) This is a curious finding to make, given that the ESM is the one which pools and coordinates financial assistance by the Member States, and it is the ESM which must be subject to strict conditionality - not the EFSM (which uses EU own resources) and does not entail any ‘coordination’ whatsoever.\(^{1688}\) The court appears to apply this criterion backwards: The ESM coordinates, the EFSM does not.

Second, it is equally clear that the ESM and EFSM cannot be divided on the basis of their objectives or criteria for the simple reason that both perform the exact same function for the exact same states in the exact same circumstances.\(^{1689}\) Recital 1 of the TESM explicitly states that the ESM ‘will assume the tasks currently fulfilled by the EFSF and the EFSM in providing, where needed, financial assistance to euro area Member States.’\(^{1690}\) In *Pringle*, the court explicitly acknowledges that ‘the ESM will, among other tasks, assume the tasks hitherto allocated temporarily to the EFSM.’\(^{1691}\) And even if such programmes were not directly passed between them, their objectives and criteria for activation are anyways identical. It must be recalled that the explicit purpose of the EFSM regulation was to ‘ensure fiscal sustainability in the euro area’,\(^{1692}\) and to ‘preserve the financial stability of the European Union as a whole’ by stopping interest rate contagion through the euro area.\(^{1693}\) Both Article 122(2) and 136(3) TFEU apply - and have applied - to safeguard the euro area as a whole.\(^{1694}\) The distinguishing objective of Article 136(3) TFEU is the ‘management of financial crises which, notwithstanding such preventative action as might have been taken, might nonetheless arise.’\(^{1695}\) Yet it is difficult to imagine how this does not precisely describe the situation Article 122(2) TFEU is meant to govern: A crisis which arises despite any preventative action that might have been taken is, 

\(^{1687}\) *Pringle v Ireland* [64].

\(^{1688}\) While the EFSM is subject to conditionality in practice, this is not a stipulation of its legal basis, whereas it is a stipulation of Member State financial assistance in Art 136(3) TFEU.

\(^{1689}\) Roderic O’Gorman, 'Thomas Pringle v Government of Ireland, Ireland and the Attorney General' (2013) 50 Ir Jur 221 (Noting that its purpose is to ‘subsume the obligations of Ireland, Portugal and Greece’ to the EFSM and EFSF).

\(^{1690}\) See: *Pringle v Ireland* [99] (emphasis added).

\(^{1691}\) *Pringle v Ireland* [103].

\(^{1692}\) Council of the European Union (9-20 May 2010)

\(^{1693}\) See, e.g., Recs 1, 4; Art 1 Reg 407/2010; Council of the European Union (2010) (emphasis added).

\(^{1694}\) Indeed, as the €10bn bailout of tiny Cyprus proved, it is not likely that the default of any Member State will ever fall outside this objective. See: Stanislas Adam , Javier Mena Parras Parras, 'The ESM through the legal meanderings of the Union’s constitutionalism:' (2013) 38 EL Rev 848, 859.

\(^{1695}\) The distinguishing objective of Article 136(3) TFEU is the ‘management of financial crises which, notwithstanding such preventative action as might have been taken, might nonetheless arise.’ *Pringle v Ireland* [58]. Yet it is difficult to imagine how this does not precisely describe the situation Article 122(2) TFEU is meant to govern: A crisis which arises despite any preventative action that might have been taken is, by definition, ‘an exceptional occurrence beyond the control of a Member State’ in the meaning of Article 122(2) TFEU.
by definition, ‘an exceptional occurrence beyond the control of a Member State’ in the meaning of Article 122(2) TFEU.

Third, the two mechanisms cannot be rendered distinct on the basis that one is ‘ad hoc’ and the other is ‘permanent.’ The issuance of financial assistance - the subject of both 122(2) and 136(3) TFEU - is coterminous on any reading. Both articles mandate the activation of financial assistance in a period of financial instability, and both contemplate its termination as soon as that instability ceases to persist. They are simply coterminous.

In any event, the entire edifice is demonstrably arbitrary. Both mechanisms could, with far less contortion, be considered to occupy the field of ‘financial assistance to a Member State’ or even ‘financial assistance where necessary to safeguard the stability of the Union.’ Either would describe the field occupied by both mechanisms more aptly. Indeed, the CJEU itself appears to fall into this trap when it lets slip that nothing in Article 122 TFEU ‘indicates that the Union has exclusive competence to grant financial assistance to a Member State’. Shared or not, if that is the competence at issue, then it is pre-emptive of a Member State mechanism under Article 2 TEU.

As one final proof, it should be noted that the EFSF not only took over from, but was fused with, the EFSM as part of contiguous operations. In that circumstance, there can be little doubt the two instruments do the same thing. Even if all of the court’s outcomes were accepted at face value, at least one of these mechanisms has been enacted in violation of EU law. Far too much is overlapping the lines of competence here to accept that this is implicitly countenanced by the Treaty architecture.

6.3.3 Encroachment on the Union Competence for Coordination

The third problem raised by the Irish Supreme Court in Pringle was that Articles 2(3) and 5(1) TFEU confer on the Union the competence for economic coordination. Yet this is something which the ESM, by setting a macro-economic adjustment programme, also appears to do. If Articles 2(3) or 5(1) describe an exclusive or shared Union competence, then the ESM will unlawfully encroach on the EU power to coordinate economic policy.

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1696 EFSM financial assistance is activated to ‘preserve the financial stability of the European Union as a whole’ and is slated to persist for ‘as long as needed to safeguard financial stability’ (Rec 1, 4; Art 2 Reg 407/2010). ESM financial assistance is activated to ‘safeguard the financial stability of the euro area as a whole’ and persists as long as Members are ‘experiencing or are threatened by severe financing problems’ (Art 3 TESM). See Adam and Parras (2013), 858.

1697 Furthermore, as the Polish Trybunał Konstytucyjny has pointed out, Member States may anyways participate in the ESM on an ‘ad-hoc’ basis. ESM & TSCG (Poland), ground 4.1.3. See also: Borger (2013),128: It is true that Article 122(2) TFEU ‘cannot be used to set up permanent capital flows to a Member State. But neither can the ESM!’

1698 Pringle v Ireland [120] [emphasis added].

1699 Under Article 2(1) TFEU, the Member States may not act in an area of exclusive EU competence; and under Article 2(2), Member States will be pre-empted from acting an area of shared EU competence occupied by the Union.

1700 Pringle v Ireland [108].

1701 Art 2(3) TFEU states that ‘The Member States shall coordinate their economic and employment policies within arrangements as determined by this Treaty, which the Union shall have competence to provide,’ and Art 5(1) TFEU states that, ‘The Member States shall coordinate their economic policies within the Union’ but that ‘the Council’ shall adopt measures to that end.
At the outset, it is not immediately necessary that this be so. Article 2(5) TFEU provides a third possibility. It states:

‘In certain areas and under the conditions laid down in the Treaties, the Union shall have competence to carry out actions to support, coordinate or supplement the actions of the Member States, without thereby superseding their competence in these areas.’

Some authors argue that economic ‘coordination’ falls within this category, and that the Union competence in economic policy ‘is a special one’, neither pre-empting or precluding Member State coordination.\footnote{Koen Lenaerts, Piet Van Nuffel, European Union Law (3rd edn, Sweet & Maxwell 2011), 128-129} This is quite convincing: The ‘coordination’ competence is listed neither as a shared competence (Articles 2(1), 4 TFEU) or an exclusive competence (Articles 2(2), 3 TFEU), and describes an obligation on the Member States to ‘coordinate their economic and employment policies within arrangements as determined by this Treaty.’\footnote{There is also no provision, for example, for the approximation or harmonisation of Member States’ laws, as often accompanies areas of Member States competence, as is often argued in the case of taxation. See: Palmstorfer (2012), pointing out that Arts 2(3) and 5(1) TFEU are listed separately from Arts 2(1) and 3 TFEU (exclusive competences) and Arts 2(2) and 4 TFEU (shared competences). See also: Servais and Ruggeri (2005), 50; Lastra (2006), 249.}

6.3.3.1 Pringle v Ireland

Curiously, the ECJ upheld ESM conditionality, but did not do so by taking the obvious route of declaring that the Member States \textit{also} had a competence to adopt coordination measures.\footnote{Pringle v Ireland [108] [64], [174].} Instead, it did the opposite. The court reasoned that ESM conditionality did not trespass on the ‘coordination’ competence only because its purpose is not to coordinate at all – rather, it is to ensure the \textit{consistency} of financial assistance with ‘the measures taken by the Union in the area of co-ordination’ under EU law.\footnote{Pringle v Ireland [110]-[111]. Conditionality, according to the court, is an altogether ‘different animal.’ Beukers and De Witte (2013), 840.} This is significant because, by holding that these competences must be separate, the court proceeds on the basis that economic coordination must be, at minimum, a shared competence capable of pre-emption. In simple, the ESM can point to the EU’s rules, but it can have none of its own:

‘[T]he ESM is not concerned with the coordination of the economic policies of the Member States, but rather constitutes a financing mechanism… While it is true that… the financial assistance provided to a Member State [is] subject to strict conditionality [which] can take the form of a macro-economic adjustment programme, the conditionality prescribed nonetheless does not constitute an instrument for the coordination of the economic policies of the Member States’\footnote{Steve Peers, ‘The stability treaty: permanent austerity or gesture politics’ (2012) 8 ECL Review 404, 410; Calleiss (2012), 105; Palmstorfer (2012); Calleiss (2012), 105. Cf: Editorial, ‘Draft Treaty on a Reinforced Economic Union’ (2012), 5; and Armstrong (2013), 603-605.}
States, but is intended to ensure that the activities of the ESM are compatible with, inter alia, Article 125 TFEU and the coordinating measures adopted by the Union.\textsuperscript{1706}

According to the court, the objective of the ESM is the ‘management of financial crises which, notwithstanding such preventative action as might have been taken, might nonetheless arise.’\textsuperscript{1707}

6.3.3.2 Analysis

The CJEU does not uphold conditionality under the ESM because Member States retain their own coordination competence; it upholds ESM conditionality because it is not coordination.\textsuperscript{1708} Yet the conclusion that the ESM does not ‘coordinate’ and is instead concerned exclusively with the ‘management of financial crises which nonetheless arise,’ as the court so puts it, is difficult to reconcile with the wording of the TESM. The stated purpose of the PCCL under Article 14 TESM, for example, is that of ‘reinforcing the credibility of [...] economic performance.’\textsuperscript{1709} This applies, no less, to Member States which have ‘a track record of access to international capital markets on reasonable terms’ and ‘whose economic conditions are still sound.’\textsuperscript{1710} Similarly, the objective of the PCCL/ECCL and SMSF is to provide financing to countries ‘whose economic conditions are still sound’, in order to ‘reinforce credibility... before they face major difficulties raising funds in the capital markets.’\textsuperscript{1711} This is the precise opposite of the conditions set out by the Court in \textit{Pringle v Ireland}. It specifically declares, on its face, that this is a coordination measures, not an indispensable finance measures.\textsuperscript{1712}

The reply to that charge is that ESM conditionality is not coordination because, as Merino so puts it, the objective of conditionality ‘is to avoid building a rival universe of economic coordination outside of the EU Treaties to the detriment of the competence of economic coordination under the EU Treaties.’\textsuperscript{1713} It is for that reason that the court holds that, ‘conditionality prescribed [does] not constitute an instrument for the coordination of the economic policies of the Member States.’\textsuperscript{1714}

But this causes more problems than it solves. Since conditionality is only legal when it ensures ‘full consistency’ with EU policy coordination, this proves only that Member State policy conditionality

\textsuperscript{1706} \textit{Pringle v Ireland} [110]-[113].
\textsuperscript{1707} \textit{Pringle v Ireland} [58].
\textsuperscript{1708} \textit{Pringle v Ireland} [111]; Pringle v Ireland (View of AG Kokott) [92].
\textsuperscript{1709} Arts 1, 2(2) ESM Guideline on the PCCL and ECCL.
\textsuperscript{1710} Arts 1, 2(2) ESM Guideline on the PCCL and ECCL.
\textsuperscript{1711} Art 1, ESM Guideline on the PCCL and ECCL [emphasis added]. The primary market support facility may be activated on the back of the precautionary credit line, and so falls within the same conditions. Art 1, ESM Guideline on the PMSF. The SMSF applies only ‘as long as the Member’s economic and financial situation remains sound.’ Guideline on the SMSF.
\textsuperscript{1712} Indeed, the ESM’s website states that it should be ‘not be regarded as a stand-alone response to the sovereign debt crisis’ and lists, as its complements, ‘the Stability and Growth Pact, the Treaty on Stability Coordination and Governance, European Semester, and the new European system of financial supervision’ - all instruments of EU economic coordination. ESM, ‘About us’ (European Stability Mechanism, <http://www.esm.europa.eu/about/index.htm> accessed 3 June 2015.
\textsuperscript{1713} Merino (2012), 1635. \textit{Pringle v Ireland} [110], [112].
\textsuperscript{1714} \textit{Pringle v Ireland} [111].
is, *prima facie*, unlawful. Any attempt to coordinate beyond the measures set out under EU law would, on this reasoning, encroach on the EU competence, and therefore be unlawful. This traps the ESM in another legal paradox: As will be shown in Section 6.4.3.2, the court later rules (in the same judgement) that financial conditionality is necessary for the ESM to be lawful under the ‘no bailout’ rule. But if strict conditionality may have no force beyond EU law, this reduces that requirement to compliance with EU law in the realm of economic policy (which, it must be recalled, the Union anyways has no competence in).\(^{1715}\) As Beukers and de Witte observe: ‘Must ESM conditionality then necessarily go further [than existing EU law]? ... if the answer is no, why then put it as an extra requirement for compatibility with Article 125 TFEU, being founded necessarily on that article?’\(^{1716}\)

The better argument might just have been that economic coordination falls under Article 2(5) TFEU and ‘does not deprive the Member States of any of their competences.’\(^{1719}\) That is not the route taken, however, and so the principle is this: Member State conditionality is a *prima facie* unlawful infringement on the Union’s coordination competence and is incapable of creating independent legal effects. ESM macroeconomic programmes are only lawful in so far as they implement EU macroeconomic programmes (which, it must be recalled, it has no competence to legislate). For the purposes of this thesis, the unavoidable conclusion is that conditional financial assistance was not countenanced by the Treaties.

### 6.3.4 The Role of EU Institutions in Economic Policy

In any event, the ECJ’s conclusion that the ESM is (Member State) economic policy – not (EU) economic coordination – poses yet another problem. Each stage of the ESM’s economic conditionality instruments are governed by secondary EU law: Under Reg 472/2013 – an instrument of secondary EU law - the Commission is tasked with assessing requests for ESM stability support (in hand with the ECB),\(^{1720}\) negotiating ESM economic conditionality (in hand with the ECB),\(^{1721}\) ensuring that the ESM macroeconomic programme is enacted into EU law by the Council,\(^{1722}\) and overseeing compliance with the ESM programme under the EU’s economic governance procedures.\(^{1723}\) Complicating matters, now that the adjustment programme is both enacted into EU

\(^{1715}\) *Pringle v Ireland* [69], [72], [111], [121], [143], [151].

\(^{1716}\) Beukers and De Witte (2013), 840.

\(^{1719}\) Calleiss (2012), 105.

\(^{1720}\) Art 6 Reg 472/2013; Arts 4(4), 13(1) TESM.

\(^{1721}\) Art 7(1) Reg 472/2013 reads: ‘Where a Member State requests financial assistance from one or several other Member States or third countries, the EFSA, the ESM, the EFSF or the IMF, it shall prepare, in agreement with the Commission, acting in liaison with the ECB and, where appropriate, with the IMF, a draft macro-economic adjustment programme which shall build on and substitute any economic partnership programme under Regulation (EU) No 473/2013 and which shall include annual budgetary targets.’ See also: Art 13(3) TESM.

\(^{1722}\) Art 7(1), 7(2) Reg 472/2013: The Commission shall ensure that the [MoU] signed by the Commission on behalf of the ESM or the EFSF is fully consistent with the macroeconomic adjustment programme approved by the Council.’

\(^{1723}\) Art 7 Reg 472/2013 reads: ‘(3)The Commission shall ensure consistency in the process of economic and budgetary surveillance with respect to a Member State under a macroeconomic adjustment programme... (4)The Commission, in liaison with the ECB... shall monitor the progress made by a Member State in the implementation of its macroeconomic adjustment programme.’ See also: Art 13(3) TESM.
law and linked to the ECB’s own OMT programme, it can no longer be said that the Commission and ECB are solely negotiating on behalf of someone else. As AG Villalón concludes:

‘Unilaterally making the purchase of government bonds subject to compliance with conditions when those conditions have been set by a third party is not the same as doing so when the “third party” is not really a third party.’

The issue raised is here simple: If conditional financial assistance under the ESM falls within the economic competence of the Member States, then the participation of the Union institutions in that mechanism must necessarily involve them in activities beyond the competences of the Union,

6.3.4.1 Pringle v Ireland

The ECJ’s response to this problem in regards to Decision 2011/199/EU has been criticised as ‘delphic’ and ‘bordering on cursory.’ With regard to that amending statement, the court simply held that:

‘Even though the TESM makes use of the Union’s institutions … that fact is not, in any event, capable of affecting the validity of Decision 2011/199, which in itself provides only for the establishment of a stability mechanism by the Member States and is silent on any possible role for the Union’s institutions in that connection.’

This would not appear to address the issue. It is important to note that it had been accepted during the preparatory work that Article 136(3) TFEU would be unlawful if it incorporated the involvement of EU institutions. This became apparent when the Parliament proposed a role for enacting EU conditionality under the co-decision procedure, but this was rejected, as it ‘would have meant that the Treaty amendment would confer new competences on the European Union and, hence, use of the simplified revision procedure would no longer have been justified.’ It is for this reason that Decision 2011/199/EU contains no word of mention of EU institutions: It is a ‘deliberate move to avoid a question of competence.’ Instead, the role of EU institutions was set out in a ‘Term Sheet’ - a commitment which would have been unlawful if it been included in Decision 2011/199/EU itself. And yet, the court’s case law since Defrenne has held that the Member States cannot

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1724 Gauweiler II (AG Cruz-Villalón) [142]-[145]: the ECB’s argument is ‘seriously undermined by its “dual role”’ as both (i) holder of a claim on a bond issued by a State and (ii) ‘negotiator and supervisor of a financial assistance programme applied to the same state, with macroeconomic conditionality included.’
1726 Pringle v Ireland [75].
1727 ‘The legal reality was, however, [that] the EU institutions were central to the ESM, and the CJEU provides scant if any guidance as to the legitimacy of such involvement.’ Craig, ‘Pringle’ (2013) 6.
1728 Beukers and De Witte (2013), 812. European Parliament Resolution of 23 March 2011 on Article 136 TFEU argued that the principles and terms of conditionality under Article 136(3) should be set by an EU regulation.
1729 O’Gorman (2013), 228.
1730 Beukers and De Witte (2013), 812.
modify the Treaty through an informal agreement. Constraining the analysis to Decision 2011/199/EU appears to turn a blind eye to the informal agreement attached to the amendment of Article 136 TFEU.

Having limited the query to the TESM itself, the ECJ’s response with regard to the TESM is that, pursuant to its case law in *Aid to Bangladesh* and *Lomé*, the extra-EU involvement of the Commission and ECB in Member State activities is lawful because, in particular:-

‘the duties conferred on the Commission and ECB within the ESM Treaty, important as they are, *do not entail any power to make decisions of their own*. Further, the activities pursued by those two institutions within the ESM Treaty *solely commit the ESM*.’

6.3.4.2 Analysis

This conclusion is difficult to reconcile with the terms of either the TESM or Regulation 472/2013. Under Article 7 of Reg 472/2013, ESM macroeconomic programmes are duplicated in EU Council decisions, and these decisions are binding in their entirety under Article 288 TFEU. Under Articles 6 of Reg 472/2013 and 13 TESM the Commission and ECB have a virtually autonomous right to negotiate, supervise, and sanction macroeconomic programmes that, at present, include dictates on health care spending, pensions, and wage negotiations, and which bind Member States under secondary EU law. Importantly, according to *Pringle v Ireland*, the legality of the ESM framework depends on the conclusion that ‘the [MoUs] concluded by the ESM … must be fully consistent with EU law,’ and, under Article 7(2) of Reg 473/2013:

‘The Commission shall ensure that the [MoU] signed by the Commission on behalf of the ESM or the EFSF is fully consistent with the macroeconomic adjustment programme approved by the Council’.

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1731 *Defrenne* [58].
1732 *Pringle v Ireland* [160]-[164]. Under that case law, the extra-EU involvement of the Commission and ECB in Member State activities will be lawful where (i) The area of involvement is not within the exclusive competence of the Union; (ii) the tasks do not involve decision-making power outside Union competence; and (iii) the tasks assigned do not alter the essential character of the powers conferred on those institutions. See: Case C-316/91 *Parliament v Council* [1994] ECR I-3283; Cases C-181 & 248/01 *Parliament v Council and Commission (Aid to Bangladesh)* [1993] ECR I-3685.
1733 Council decisions are binding under Art 288 TFEU.
1734 See Angelos Dimopoulos, *The Use of International Law as a Tool for Enhancing Governance in the Eurozone and its Impact on EU Institutional Integrity* in Maurice Adams, Federico Fabbrini and Pierre Larouche (eds), *The Constitutionalization of European Budgetary Constraints* (Hart Publishing 2014) 41, 51, complaining that the Commission and ECB ‘have a great degree of discretion to develop new standards and procedures when they exercise their powers to monitor and assess Member States’ conduct under the ESM.’ See also: Craig (2014), 27-18 noting that ‘the ruling leaves a legal black hole, according to a broad substantive discretionary power to EU institutions with no legal procedural safeguards.’ O’Gorman (2013), 229 criticises the ‘resolute determination of the court not to even consider whether the powers given to the Commission and the ECB by the ESB Treaty would constitute an increase of their competence.’
1736 Art 7(2) Reg 472/2013. Art 7(1) Reg 472/2013 states that the ‘macroeconomic adjustment programme’ will ‘build on and substitute’ any economic partnership programme already in place pursuant to Reg 473/2013.
How is it that the terms of these macroeconomic programmes are not acts of EU institutions, but, under Articles 6-7 of Reg 472/2013, the Member States are legally prohibited — by an act of EU law — from enacting anything other than policies selected by the Commission and ECB and enacted into binding EU law by the Council? *Ledra v Commission and Council* is elucidative of the dilemma. In that case, the ECJ held that the Commission’s duty to ensure that the MOU is ‘fully consistent with EU law’ was capable of constituting an act attributable to that EU institution grounding an action for non-contractual liability against the *Commission* (note: not the ESM).1737 Yet in that same case, the challenge to this same act on *ultra vires* grounds was dismissed on the basis that the Commission and ECB do not have ‘any power to make decisions on their own and … solely commit the ESM.’1738 But these are disjunctive propositions. Certainly, the fact that the Commission has a duty to ensure that the MoUs concluded by the ESM are ‘fully consistent with EU law’ means that the Commission is not, obviously, doing nothing.1739 The Union cannot have it both ways.1740

In any event, *Pringle v Ireland* ignores the reality that the Commission and Council do take decisions which can only be attributed to their own acts according to existing case law. In C-409/13 *Council v Commission*, for example, the ECJ held that the Commission’s power to ‘determine the subject-matter, objective and content’ of a legislative proposal, as well as ‘the power … to alter its proposal or even, if need be, withdraw it’ *before* its being acted upon by the Council was a reviewable act in and of itself.1741 This is, by any measure, the same power the Commission has under the TESM and Articles 6 and 7 Reg 472/2013.

As will be shown in Section 8.5, all of this has forced the ECJ into an ultimately untenable position post-*Pringle*. The Commission and ECB have a power – under binding secondary EU law – to take specific decisions when drafting macroeconomic programmes, and these decisions are: (i) acts of EU institutions which are held to be capable of grounding an action for non-contractual liability in *Ledra*;1742 (ii) acts which are duplicated in EU Council Decisions under Reg 472/2013 and binding under Article 288 TFEU;1743 (iii) they are acts which are held to constitute ‘binding legal commitments with the Commission [and] ECB’ in *Dowling v Minister of Finance*;1744 (iv) they are acts which predicate the OMT;1745 and (v) they are classified as reviewable legal acts of EU institutions according to C-409/13 *Commission v Council*.1746 However, if the CJEU acknowledges

1737 *Ledra (Opinion of AG Wahl)* [55].
1738 *Case T-289/13 Ledra Advertising v Commission and ECB* (General Court, Order of 10 November 2014) [45]. Approved in *Ledra (Opinion of AG Wahl)* [55]. See also: *Case T-327/13 Mallis [41]-[50]; C-105-109/15 P Mallis [55]-[57].
1740 This issue is examined in greater detail against the boundaries of fiscal sovereignty in Section 8.5.
1742 C-8-10/15 P Ledra.
1743 Art 7 Reg 472/2013.
1744 In *Dowling* [41.2](4) and *Dowling v Minister for Finance* [25]. See: Section 8.5.3.
1745 *Gauweiler II (Opinion of AG Cruz-Villélon)* [145].
1746 *Case C-409/13 Commission v Council* [70]-[74]; C-613/14 *Irish Asphalt*. 

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these acts as acts of EU institutions, then it will be difficult not to acknowledge that they are also *ultra vires*. So it does not. The issue is examined in greater detail where it arises with regards to fiscal sovereignty in Chapter 8.\textsuperscript{1747} However for present purposes it is sufficient to remark that, either way, financial conditionality drafted by EU institutions and governed by EU law is not countenanced by the Treaty.

## 6.3.5 Conclusion on Competence

The inability to *genuinely* reconcile the ESM’s legal framework with the allocation of competences provides the first testable indication that that conditional financial assistance has exceeded the allocation of competences inscribed in the Treaty and is now dependent on the continuous acquiescence of Member State *ultra vires* and constitutional identity jurisdictions. Proof for this proposition is provided by *Gauweiler v Bundesbank III*, in which the BVerfGE ruled that the ECJ’s interpretation failed to resolve the ‘overlap’ between the ESM, EFSM and the OMT, and concluded that the latter does, in fact, exceed the constitutional boundaries in this thesis.\textsuperscript{1748} The BVerfGE then not only placed six restrictions on the operation of a (technically) supreme act EU law, but placed the *Bundesbank* and the *Bundestag* in a position of supervision over it. Further proof is found in the string of 2011 ESM rulings in which the German BVerfGE,\textsuperscript{1749} Irish Supreme Court,\textsuperscript{1750} the Austrian VfGH,\textsuperscript{1751} the Finnish *Perustuslakivaliokunnan*,\textsuperscript{1752} the Policy *Trybunai*\textsuperscript{1753} and the Estonian *Riikikohus* all,\textsuperscript{1754} to varying extents, duly subjected the ESM to their own constitutional tests for fiscal sovereignty, capping financial commitments to the extent of the parliamentary authorisation. This is so despite the fact that, as will be shown, the ECJ recognised no such limits of liability in its ruling on the ‘capital calls’ provisions of the ESM.\textsuperscript{1755}

The findings of this section imply a further hypothesis pursued for the second half of this chapter: Conditional financial assistance outside the terms of Article 122(2) TFEU was not countenanced by the Treaty drafters as suitable to achieve the mandate under Article 119 TFEU, and so should not be compatible with the construction of Articles 122-125 governing access to public finance for that purpose. The Treaty drafters placed but one emergency pipeline for non-market financial flows in the framework of Articles 121-126 TFEU. As the Union has enacted its own financial assistance mechanism (EFSM) under Article 122(2) TFEU, this is, in principle, preclusive of any others. For

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\textsuperscript{1747} See: Section 8.5

\textsuperscript{1748} *Gauweiler III (Germany)* [3](b)-(c): ‘The restrictive parameters developed by the Court of Justice do not completely remove the character of the OMT programme insofar as it encroaches upon economic policy.’

\textsuperscript{1749} *Re ESM I (Germany); Re ESM II (Germany)* [161]-[162].

\textsuperscript{1750} Spending obligations ‘must come from funds already committed by Ireland (with the approval of the Dáil).’ *Pringle I (Ireland Supreme Court)* [8.14] per Clark J.

\textsuperscript{1751} *ESM (Austria)* [104]-[105].

\textsuperscript{1752} *Opinion 25/2011 on the ESM (Finland); Opinion 13/2012 on the ESM (Finland).*

\textsuperscript{1753} *ESM & TSCG (Poland),* 305.

\textsuperscript{1754} *ESM (Estonia)* [105]-[106], [144].

\textsuperscript{1755} See below, Section 6.4.3.4. *Pringle v Ireland* [144]-[146].

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the purposes of this thesis, the unavoidable conclusion is that conditional financial assistance under the ESM was not countenanced by the Treaties.

### 6.4 Conformity with the Substantive Law of the Treaty

Competence issues aside, in order for the ESM to be lawful, financial assistance must be permissible under the ‘no bailout’ rule inscribed in the Treaty since Maastricht. As Article 125 TFEU is not amended, this must be so irrespective of any effect which Article 136(3) TFEU has on that provision.\(^{1756}\) The most Article 136(3) is capable of providing is a written description of a (formerly unwritten) extant *lex specialis* under Article 125 TFEU.\(^ {1757}\) In short, financial assistance is in violation of EU law unless it can be shown that it is *already* permitted under the ‘no bailout’ rule.

Article 125(1) TFEU consists of two sentences, the first addressed to the Union and the second addressed to the member States.\(^ {1758}\) In identical terms, those sentences state that:

> ‘The Union/A Member State *shall not be liable for or assume the commitments of* central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project.’ (Emphasis added).

There are two competing interpretations of this provision prevalent among legal scholars, and *Pringle v Ireland* has done little to quell the dispute. Merino encapsulates the operative issue thusly:

> ‘Does the granting of loans and credits under these mechanisms amount to “being liable or assuming the commitments” of a Member State within the meaning of Article 125 TFEU?’\(^ {1759}\)

The broad (purposive) interpretation of Article 125 TFEU is of a ‘no bailout’ rule *stricto sensu*. This view enjoys resilient support among legal commentators and has a strong textual basis in the Treaty.\(^ {1760}\) Ruffert and others point out that the language of Article 125(1) TFEU is ‘rather explicit.’\(^ {1761}\) It states that the Member States and the Union ‘shall not’ engage in such activities - language which implies a ‘hard obligation and thus a prohibition.’\(^ {1762}\) Article 125(2) TFEU itself refers to the ‘prohibition’ set out in Article 125(1).\(^ {1763}\) Declaration No. 6 on Article 100 EC (now 122 TFEU) refers to Article 125 as the ‘no bail-out rule’.\(^ {1764}\) The German version of Declaration No.

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\(^{1756}\) As the court held in *Pringle v Ireland* [185], Article 136(3) TFEU has no legal effects of its own - ‘the right of a Member State to conclude and ratify the TESM is not subject to the entry into force of Decision 2011/199.’

\(^{1757}\) Commission Opinion on the draft EC Decision Amending Article 136 COM(2011) 70 final ; Opinion of the ECB of 17 March 2011 on Article 136 TFEU, para 5; European Council Conclusions of 16-17 December 2010, recs 1, 6.

\(^{1758}\) Recited in full at Chapter 2, Section 2.3.1.1, p 131.

\(^{1759}\) Merino (2012), 1626.


\(^{1761}\) Ruffert (2011), 1785. See also: Lastra (2006), 253 ‘The ‘no bailout’ clause is clear and precise.’

\(^{1762}\) Palmstorfer (2012), 775.

\(^{1763}\) ‘The Council, on a proposal from the Commission and after consulting the European Parliament, may, as required, specify definitions for the application of the prohibitions referred to in Articles 123 and 124 and in this Article.’

\(^{1764}\) Declaration No 6 (emphasis added).
6 refers to Article 125 as a ‘Verbot’ or ‘ban’ on financial assistance.\(^{1765}\) This language is adopted by the ECJ in Pringle itself, which refers to the ‘no bailout clause’ - literally, a provision that allows for no bailouts.\(^{1766}\)

As shown in Chapter 2, the broad interpretation also finds explicit support in the travaux préparatoires of the Maastricht Treaty.\(^{1767}\) According to the preparatory work, its purpose is ‘to dispel any investor’s doubt, or hope, about the risk they run in financing governments,’\(^{1768}\) and so ‘ensure that the financial markets exercise a degree of discipline.’\(^{1769}\) The broad interpretation is informed by this purpose, whatever the structure of the financing relationship.\(^{1770}\)

The narrow interpretation, by contrast, is derived from a literal reading of the text of Article 125 TFEU. According to this view, the wording ‘shall not be liable for’ or ‘assume the commitments of’ prohibits only direct relationships of guarantee which result in the direct assumption of liability to the Member State’s creditors.\(^{1771}\) As the Commission argues, ‘Lending to a euro-area Member State - as opposed to assuming its debt - is not in contradiction with Article 125 TFEU.’\(^{1772}\) A proponent of this interpretation, Merino explains it this way:

‘Article 125 prohibits the Union or another Member State from guaranteeing the debt of any Member State. Guarantees would amount to “being liable for” or “assuming the commitments” of the guaranteed party. Any direct relationship of guarantee with a Member State’s creditors would breach the no-bailout clause. However, this prohibition does not appear to extend to types of financial assistance, such as loans or credits... where the beneficiary of the assistance is held to pay them back.’\(^{1773}\)


\(^{1766}\) Pringle v Ireland [129], [132] [emphasis added]. See also, Angela Merkel: ‘We have a treaty under which there is no possibility of paying to bailout states in difficulty.’ Fillmer (1 March 2010).

\(^{1767}\) See: Chapter 2, Section 2.3.1, pp 130-133. Beck (2014), 244 summarises: ‘the discussion surrounding the launching of the Emu in the 1990s abundantly confirms that Art125 TFEU was intended precisely to preclude such mutual aid, whether conditional or not.’ Wyplosz (1997), 14, noting that the ‘no bailout’ clause ‘explicitly forbids the rescue of one government either by its fellow members or by community institutions, including the ECB’ (noting German concerns that it might ultimately be circumvented); Beck (2014), 244.


\(^{1769}\) Monetary Committee, EMU Beyond Stage I (1990), 2. ‘Each Member State must bear the responsibility for its own debt management and must ensure that it is in a position to honour its engagements. It must be clear that neither the Community nor the other Member States stand behind a Member State’s debts.’

\(^{1770}\) As Borger (2013), 130 observes, ‘Any form of assistance by the Union or its Member States, either direct or indirect, ex ante or ex post, would distort the functioning of this market mechanism.’ Beck (2014), 244; Lars P Feld and Thushyathan Baskaran, ‘Federalism, Budget Deficits and Public Debt: On the Reform of Germany’s Fiscal Constitution’ (2010) 6 Rev Law Econ 365, 379: ‘the no-bail-out clause … prohibits government of Euro-area countries from bailing out excessively indebted member states. Thus, Germany is not allowed to bail out Greece.’

\(^{1771}\) Pringle v Ireland (View of AG Kokott), 114-115, 121. For proponents of this view, see: Athanassiou (2011); Merino (2012); Paul De Grauwe, ‘The Greek crisis and the future of the Eurozone’ (2010) 2 Intereconomics 89, 91.


\(^{1773}\) Merino (2012), 1627; Pringle v Ireland (View of AG Kokott) [114].

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It is important to emphasise this difference in scope: Under the narrow interpretation, the concern of Article 125 TFEU is not the financing of another Member State’s liabilities. It is concerned only with *how* they are financed. A Member State could, theoretically, finance another Member State’s liabilities in perpetuity, as long as no direct guarantee exists between the lending Member State and the debtor Member State’s creditors.

**Permitted under the Narrow Interpretation**

[Diagram showing permitted transactions]

**Prohibited under the Narrow Interpretation**

[Diagram showing prohibited transactions]

In *Pringle v Ireland*, the Court of Justice adopted the narrow interpretation. This was done on the basis of three stages of analysis: [6.4.1] First, on a textual analysis of Article 125 TFEU, the court ruled that the wording ‘shall not be liable for’ or ‘assume the commitments of’ did not prohibit all financial assistance. [6.4.2] Second, the court verified its textual analysis with a comparison of the text of Articles 122 and 123 TFEU: since those provisions did not also prohibit *all* forms of financial assistance whatsoever, this proved that Article 125 TFEU did not preclude *all* financial assistance whatsoever. [6.4.3] Third, the court conducted a teleological interpretation of Article 125 TFEU in order to determine what *kinds* of financial assistance are compatible with the ‘no bailout’ rule. However, it must be noted that the issue of the narrow interpretation had already been decided at the first (textual) stage of analysis. In the absence of any textual basis for determining what, or how many, kinds of financial assistance there might be, the teleological analysis merely became necessary to give contour to the narrow interpretation.

**6.4.1 The Textual Interpretation of Article 125 TFEU**

The narrow interpretation of Article 125 TFEU is ultimately adopted on the basis of a literal textual analysis confined to a single paragraph. The operative paragraph to that effect is as follows:

‘[130] It must be stated at the outset that it is apparent from the wording used in Art125 TFEU, to the effect that neither the Union nor a Member States are to be “liable for ... the commitments” of another Member State or “assume [those commitments]”, that the article is not intended to prohibit either the Union or the Member States from granting any form of financial assistance whatever to another Member State.’

On this basis, the court concluded:
‘[136] Art.125 TFEU does not prohibit the granting of financial assistance by one or more Member States to a Member State which remains responsible for its commitments to its creditors.\textsuperscript{1774}

The edifice of the narrow interpretation is that the scope for financial assistance exists \textit{outside} of Article 125 TFEU, rather than existing as an unwritten \textit{lex specialis} through that provision. Member States were always permitted to provide financial assistance \textit{except} where prohibited by Article 125 TFEU (which applies only to guarantees). It is on this basis that the scope for financial assistance is held to exist: Article 125 is narrow – it is not holed-through.

As will be shown, however, this is logically impossible. It is possible to accept that Article 125 TFEU is not an ‘absolute’ bailout provision, but if this is so, any scope for financial assistance must, necessarily, come by \textit{lex specialis}. This is a necessity drawn from the decision in \textit{Pringle} itself: Having determined that Article 125 TFEU does not prevent all forms of financial assistance, the court ultimately holds that financial assistance is not compatible with Article 125 unless three conditions are derived from Article 125 TFEU itself are met.\textsuperscript{1775} They are: (i) that the recipient Member State remains responsible for its commitments to its creditors;\textsuperscript{1776} (ii) that loans are subject to strict conditionality;\textsuperscript{1777} and (iii) that it is indispensable for the stability of the euro area as a whole.\textsuperscript{1778} The sum of the conditions read in by the court is that Article 125 TFEU has two effects:

(i) It prohibits the direct assumption of guarantees in any circumstances (defined as the transfer of liability from debtor to guarantor); and

(ii) It prohibits all other form of financial assistance, unless they are also (a) subject to strict conditionality and (b) indispensable for the stability of the euro area as a whole.

This latter point, the court’s placing of restrictions on loans, etc., necessarily implies that Article 125 TFEU applies to all financial assistance. This is denied by the court: The edifice is that loans are permitted because they are not covered by Article 125. If that were the case, however, it would be impossible for Article 125 TFEU to place substantive conditions on loans, as the court subsequently finds that it does. This may be explained simply: \textit{Expressio unius est exclusio alterius}, a prohibition whose scope is limited to guarantees could not also place such restrictions as ‘indispensability’ and ‘strict conditionality’ on loans if they were outside its scope.\textsuperscript{1779} As will be shown, this flawed starting point becomes the root of a number of internal incoherencies.

\textsuperscript{1774} Once again, it must be emphasized that, while a comparative analysis and a teleological interpretation are later employed to verify and define that conclusion, the narrow interpretation is adopted on the basis of \textit{Pringle v Ireland} paragraph 130 alone. Para 136 added for context.

\textsuperscript{1775} The activation of financial assistance ‘is not compatible with art.125TFEU unless’ those conditions are met: \textit{Pringle v Ireland} [136]-[139].

\textsuperscript{1776} See: Section 6.4.3.1.

\textsuperscript{1777} See: Section 6.4.3.2.

\textsuperscript{1778} See: Section 6.4.3.3.

\textsuperscript{1779} Jones (2013), 1124-1132.
6.4.1.1 The Golden Rule of Textual Interpretation

The literal interpretation is initially adopted on the basis of a textual analysis of Article 125 in isolation, and it is that which is considered here first.\(^{1780}\) Under the court’s interpretation, Article 125 TFEU stands for the proposition that loans, etc. are permitted in some (unspecified) circumstances, but in other (unspecified) circumstances they are not. Save for conjuring the invisible spirits of teleology, there is no way to discern what, or how many, exceptions there may be. Is such a nebulous interpretation compatible with the wording of Article 125 TFEU, according to ordinary canons of textual interpretation?

It would seem fantastic.\(^{1781}\) First, under the golden rule of statutory interpretation, the literal of a provision must not be inconsistent with, or circumvent the plain meaning of, the text of the law.\(^{1782}\) In that regard, the language and intention of Article 125(1) is nothing if not ‘clear and precise’: The words ‘shall not’, ‘prohibition’, ‘verbot’ and ‘no bail-out rule’ do not avail of any unwritten exceptions.\(^{1783}\) There is certainly no textual basis for exceptions in the event of instability in the euro area and strict conditionality.\(^{1784}\) Yet, under the court’s textual interpretation, an unambiguous prohibition is rendered ambiguous.\(^ {1785}\) That the ECJ and the AG arrive at conflicting interpretations of what kinds of assistance are compatible with Article 125 (none of which ‘necessarily follow from Article 125 TFEU’) should constitute sufficient proof of this.\(^ {1786}\)

6.4.1.2 The Plain Meaning Rule

Second, under the plain-meaning or European grammatical rule, ‘Words should be read as saying what they say.’\(^ {1787}\) Leaving aside the fact that this approach is only appropriate where the enactment is only grammatically capable of one meaning and an informed interpretation raises no real doubt as to that meaning (which does not apply here), this would seem to be the only approach capable of justifying a narrow interpretation.\(^ {1788}\) According to the ECJ’s interpretation, financial assistance is lawful because the ESM ‘does not act as a guarantor of the debts of the recipient Member States’

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\(^{1780}\) Once again, it must be emphasized that, while a comparative analysis and a teleological interpretation are later employed to verify and define that conclusion, the narrow interpretation is adopted on the basis of the textual stage alone.

\(^{1781}\) See: Palmstorfer (2012); Craig, ‘Pringle’ (2013); Everson (2015), 479: Article 125 should ‘surely’ be held ‘to mean what it clearly appears to mean in plain language—that the Treaty prohibits any form of debt financing between member States.’


\(^{1785}\) As Ruffert (2011), 1785 observes, the narrow interpretation ‘goes against the ratio of the provision.’

\(^{1786}\) Beukers and De Witte (2013), 838. The Advocate General considers there to be no requirement on financial assistance under Art 125 TFEU other than that it may not guarantee or discharge the liabilities of other Member States. Pringle v Ireland (View of AG Kokott) [121], [124], [148], [134]-[144]. The CJEU held that (i) Article 125 prohibits only direct guarantees resulting in discharge of liability (i.e., loans may lawfully be used to discharge a liability), (ii) financing must always be subject to strict conditionality, and (iii) financial assistance must be indispensable to the stability of the euro.


\(^{1788}\) Jones (2013), 508.
and does not ‘guarantee the debt’ of defaulting members because ‘the defaulting ESM Member State remains bound to pay its part of the capital.’\footnote{1789} In short, Article 125 is interpreted as a prohibition on guarantees which discharge the liability of the debtor. Does this literal translation meet the plain-meaning rule?

Once again, it would seem impossible. As Tomkin points out, this interpretation ‘implies the premise that a defining characteristic of a guarantee is that it absolves a primary debtor of its debtor status.’\footnote{1790} However, the normal definition of guarantee in law ‘does not necessarily or even ordinarily affect the primary liability of a debtor.’\footnote{1791} Andrews and Millet, \textit{Law of Guarantees}, note that, ‘The essential distinguishing feature of a contract of guarantee is that the liability of the guarantor is always ancillary, or secondary, to that of the principal, who \textit{remains primarily liable to the creditor}.’\footnote{1792} McDermot, \textit{Contract Law}, observes that ‘a contract is not a guarantee unless there are three parties, the creditor, the principal debtor and the secondary debtor.’\footnote{1793} A surety which preserves the liability of the debtor is still a guarantee.\footnote{1794}

The import of Tomkins’s argument is that the court’s bespoke definition of ‘guarantee’ does not give effect to the plain-meaning of the provision – even if one accepts the court’s own narrow interpretation as a prohibition only on guarantees.\footnote{1795} Indeed, in \textit{Gauweiler v Bundesbank}, AG Villalón recognised that there is no difference - in form or function - between a prohibited ‘loan’ and the assumption of liabilities through the purchase of a government bond.\footnote{1796} The literal interpretation ‘fails on its own terms.’\footnote{1797}

\subsection{6.4.1.3 The Mischief Rule}

Finally and most obviously, if ‘bail-outs’ are what is being prohibited, then the narrow interpretation does nothing of the sort.\footnote{1798} It must be recalled that the preparatory work was quite clear on the

\begin{itemize}
\item \textit{Pringle v Ireland} [138]-[139] [144]-[145].
\item Tomkin (2013), 181.
\item Tomkin (2013), 181.
\item Paul A McDermot, \textit{Contract Law} (Tottel Publishing 2006) 191, para 4.08
\item Andrews and Millet (2011) para 1-013: ‘A contract of suretyship which contains a provision preserving liability in circumstances in which a guarantor would otherwise be discharged \textit{will usually be construed as a guarantee}, because such a provision would be unnecessary if the contract was an indemnity.’
\item As an additional matter, it should also be noted that strict conditionality is also perfectly reconcilable with a relationship of guarantee. \textit{Black’s Law Dictionary} (2009), 774 refers to a ‘contingent guarantee’ as ‘a guaranty in which the guarantor will not be liable unless a specified event occurs.’ Andrews and Millet (2011), 1-003 note that the liability of a guarantor may also be defined as a liability ‘but to procure (or “see to it”) that the principal performs his obligations.’ In practice, any guarantee on the scale envisioned by a sovereign bailout will always be subject to conditions: Tomkin (2013), 182.
\item \textit{Gauweiler II} (Opinion of AG Cruz-Villalón): ‘A person who acquires governments bonds from an issuing State is, by definition, financing that State, directly or indirectly, and does so for consideration that makes the legal transaction into a sort of loan. The holder of the government bond has a right to seek repayment of a debt from the issuing State, thus converting it into a creditor of the State. … The transaction entered into by the two parties, the issuing State and the purchaser of the government bond, therefore has the same structure as the granting of a loan.’
\item Beck (2014), 244.
\item Palmstorfer (2012) 775.
\end{itemize}
purpose of the ‘no bailout’ rule: It was to ‘be clear that neither the Community nor the Member States stand behind a Member State’s debts,’\(^\text{1799}\) and ‘to dispel any investor’s doubt, or hope, about the risk they run in financing governments.’\(^\text{1800}\) There can be little doubt that the narrow interpretation does not accomplish either of these things. As Beck observes, the so-called “no bail-out” clause does little or nothing to restrict the mutualisation of debt within the euro zone.\(^\text{1801}\)

### 6.4.2 The Systemic Interpretation of Articles 122-125 TFEU

At the second stage of analysis, the Court in *Pringle* supported its literal interpretation of Article 125 with a cross-textual comparison of Articles 122 and 123 TFEU. First, the court noted that since Article 122 TFEU permitted *ad hoc* Union financial assistance to states, this implied that Article 125 TFEU could not be an absolute prohibition:

‘First, Art122(2) TFEU provides that the Union may grant *ad hoc* financial assistance to a Member State which is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control. If Art125 TFEU prohibited any financial assistance whatever … Art122 TFEU would have had to state that it derogated from Art125 TFEU.’\(^\text{1802}\)

Second, the court compared the wording of Article 123 TFEU (which prohibits ECB ‘overdraft facilities or any other type of credit facility’) with the wording of Article 125. The court reasoned that since Article 123 employed stricter language than Article 125, this ‘supports the view that the prohibition stated [in Article 125(1) TFEU] is not intended to prohibit any financial assistance whatever to a member State.’\(^\text{1803}\)

In that regard, it must be noted that the court’s comparison falls far short of what might properly be termed a systemic analysis. The court undertakes a purely textual comparison. It did not recognise the legal framework as having any effect greater than its disaggregated parts.\(^\text{1804}\)

As shown in Chapter 2, neither the text nor purpose of Article 125 TFEU can be read independently of its preceding articles.\(^\text{1805}\) It is merely the ‘final piece’ of an integrative structure which functions to cut off access to all non-market public finance under Articles 122, 123, 124, and 125 TFEU.\(^\text{1806}\)

That these four provisions comprise a single interlocking framework for that purpose is referenced

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\(^{1799}\) Recited in full, *infra*, Chapter 2, Section 2.3.1.1, p 128. Monetary Committee, EMU Beyond Stage I (1990), 2.


\(^{1801}\) Beck (2014), 243, ‘All it does, on the Court’s implausible reading, is to prohibit a particular legal construction among many other such constructions, of the precise form that financial assistance and the assumption of financial risk and debt mutualisation between euro zone countries may take.’

\(^{1802}\) *Pringle v Ireland* [131]

\(^{1803}\) *Pringle v Ireland* [132].

\(^{1804}\) Although the unitary function of these provisions was later recognised by AG Cruz-Villalón in *Gauweiler II (Opinion of AG Cruz-Villalón)* [131] no such approach was taken by the Court in *Pringle*.

\(^{1805}\) See: Chapter 2, Section 2.3.1, pp 130-136. Louis (2010), 977.

\(^{1806}\) *Gauweiler II (Opinion of AG Cruz-Villalón)* [131]; Louis (2010), 977; Borger (2013), 119; Smits (2015), 1141.
clearly throughout the Maastricht Treaty *travaux préparatoires* of the Monetary Committee,\(^{1807}\) the Committee of Governors,\(^{1808}\) and the Commission,\(^{1809}\) and is stated explicitly in various treaty and secondary law provisions.\(^{1810}\)

On a systemic reading, if there were meant to be some silent, unspecified avenue for financial assistance, it would seem necessary to replicate the provisions of Article 143 TFEU (ex 108 EEC) for the Euro Area. As Palmstorfer points out, Article 143 TFEU belongs to the oldest parts of the Treaty and the architects of the EMU were aware of it.\(^ {1811}\) Yet they didn’t use that provision for the EMU or create a new one in its likeness. They rescinded it.\(^ {1812}\) Palmstorfer explains:

‘Should a Member State bang at the door of the others asking them for help, Art125(1) TFEU in its current state forbids them to provide financial assistance. This provision is an expression of the fact that the EMU was not designed to be a fiscal union.’\(^ {1813}\)

It is apparent that this interlocking framework would not have this effect if public finance could be provided through one of the three barred doorways outside of Article 122(2) TFEU (Articles 123-125 TFEU). This should be self-evident: To allow financial assistance on non-market terms, where previously there was none, undeniably negates an integrative framework constructed to close off ‘hope’ of that possibility.\(^ {1814}\) Under the text of the Treaty, EMU members cannot access financial assistance under Article 122 TFEU on the same basis that non-Euro Member States can under Article 143 TFEU.\(^ {1815}\) The corralling of any finance-seekers into the ‘out of control emergency’ test of Article 122(2) is rendered completely ineffective if just one of its constituent barriers is compromised. It is no answer to dismiss this deliberate action on the basis of a hidden exception to Article 125 TFEU. It is only the barring of all three doors which exposes Member States to the disciplines of the markets, and a systemic interpretation which causes a breakdown in the operation of this integrative whole cannot be consistent with the function of its disaggregated parts.

### 6.4.2.1 The Interpretation of Article 122 TFEU

All that exists in the way of a financial assistance umbrella for the Euro Area is Article 122(2) TFEU, which provides Union financial assistance where a Member State is seriously threatened with

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1807 Chapter 2, Section 2.3.1.1, p 128. Monetary Committee, EMU Beyond Stage I (1990), 2.
1809 Chapter 2, Section 2.3.1.1, p 128. Commission of the EC, ‘Contributions by the Commission’ (1990), 15; Commission, ‘A stability Pact to Ensure Budgetary Discipline’ II/163/96-EN, 18 March 1996, 15-16: ‘The Treaty contains a number of elements that reinforce the role of market pressure in favour of fiscal discipline… There are four main provisions in the Treaty stating in concrete terms the above mentioned principle [referring to Articles 122,123,124, 125 TFEU].’
1810 Article 125(2) TFEU refers to ‘the prohibitions referred to in Articles 123, 124 and [125]’, and Reg 3603/03, describes the purpose of this framework as ‘the submission to the public sector in its financing operations.’
1811 Palmstorfer (2012), 779.
1812 Derogating Member States (non-Euro countries) still enjoy the protection of Art 143 TFEU.
1813 Palmstorfer (2012), 778-779.
1815 Athanassiou (2011), 569.
severe difficulties caused by natural disasters or exceptional occurrences beyond its control. The court’s lesson from this provision is that its very existence proves that Article 125 is not absolute. That much is self-evident: The latter cannot render the former redundant. The obvious way to reconcile these provisions would therefore be to conclude that, *lex specialis derogat legi generali*, Article 122(2) TFEU is an exception to Article 125.

But that would mean that Article 125 TFEU is a general prohibition on all forms of financial assistance, and so this conclusion is denied by the court. Instead, the court posits that Article 122(2) TFEU proves that there are routes for financial assistance which fall outside the scope of Article 125 TFEU – of which Article 122(2) is merely one. However, as explained above, the court’s position that financial assistance is already permitted outside of Article 125 TFEU, rather than through exceptions to that rule, is logically impossible.

First, the court’s interpretation of Article 122(2) TFEU as a route around, not through, Article 125 TFEU, renders Article 122(2) TFEU itself redundant. It must be recalled that Article 125 TFEU contains two identical sentences, one addressed to the Union and one addressed to the Member States. Since the wording of both sentences in Article 125(1) are identical, they must have identical meaning. The only exception to either sentence in the Treaties is Article 122(2) TFEU, which allows only for *Union* financial assistance in closely circumscribed circumstances. There is no such exception addressed to Member States anywhere in the Treaty. Yet the court in *Pringle* holds that Article 136(3) TFEU represents a Member State power which has always existed under 125 TFEU. Since the sentences are identical, it stands to reason that if there is an (unwritten) Article 136(3)-sized hole applying to the Member States under the second sentence of Article 125(1), there must also be an (unwritten) Article 136(3)-sized hope applying to the Union under the first sentence. This renders Article 122(2) TFEU redundant. Article 136(3) TFEU is much wider than Article 122(2).

Under Article 122(2), ‘The occurrence has to be exceptional and not manageable under any other Treaty provisions.’ Article 136(3) TFEU has no such restriction. As Palmstorfer observes ‘Why exclude such assistance loans from the no bail-out ban if they are not caught by it anyway?’

Second, if the court’s narrow interpretation of the second sentence (addressed to the Member States) is correct, it would mean that the first sentence (addressed to the Union) does not prohibit *Union* financial assistance ‘where indispensable for the financial stability of the euro area as a whole.’ Yet the court has already rejected this interpretation of the first sentence of Article 125(1) - Union

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1816 Art 122(2) TFEU reads: ‘Where a Member State is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control, the Council, on a proposal from the Commission, may grant, under certain conditions, Union financial assistance to the Member State concerned.’ See: Section 2.3.1.4, pp 133-136.
1817 See: Palmstorfer (2012), 778.
1818 Beck (2014): ‘it would be counterintuitive for the Treaty expressly to provide for financial assistance for specific purposes and limited amounts but be entirely silent about, and yet impliedly authorise, a financial assistance mechanism for a much broader purpose and on a much larger scale.’
1819 Louis (2010), 981.
1820 Palmstorfer (2012), 778. See also: Borger (2013), 129.
financial assistance is prohibited other than in situations under Article 122(2) TFEU. At para 116 of Pringle, Article 122(2) TFEU was held not to constitute an appropriate legal basis for the ‘stability of the euro area as a whole’ for this reason.\textsuperscript{1821} There is no attempt by the court to explain, if the two sentences of Article 125 TFEU are identical, why court ascribes different interpretations to them.

AG Kokott suggests that Article 122(2) TFEU is a competence provision - ‘a power which the Member States on the other hand do not need.’\textsuperscript{1822} But this, too, violates the rule against surplusage. If Article 122(2) TFEU were to be interpreted as a standalone competence for Union financial assistance rather than a \textit{lex specialis}, this would render the first sentence of Article 125(1) TFEU redundant. This is so because the EU can only ever act within its competences. Why ban EU bailouts under Article 125 TFEU if they can never be given outside of Article 122(2) TFEU in the first place? That cannot be correct either. The better view is that both articles do what they say they do: Article 125(1) TFEU applies the same prohibition to both the Member States and the Union; and Article 122(2) creates a \textit{lex specialis} for the Union.\textsuperscript{1823} If it were otherwise, financial assistance would simply need not comply with either provision.

As shown in Chapter 2, this reading is made explicit in the preparatory work.\textsuperscript{1824} It is also made explicit by Declaration No. 6 on Article 100 EC, which refers to ‘decisions regarding financial assistance, such as are provided for in Article [122 TFEU] \textit{and} are compatible with the ‘no bail-out’ rule laid down in Article [125 TFEU].’\textsuperscript{1825} By stating that financial assistance under Article 122 TFEU must also be compatible with Article 125 TFEU, Declaration No. 6 makes clear that they are cumulatively applicable.\textsuperscript{1826} It means, simply, that the Union has been granted a power to grant financial assistance and that it can only be exercised by having due regard to the “no bailout” clause.\textsuperscript{1827}

\textbf{6.4.2.2 The Interpretation of Article 123 TFEU}

The court’s interpretation of Article 123 TFEU founders on similar difficulties. The court reasons that, since Article 123 uses broader and much more specific terminology than Article 125 TFEU (i.e.  

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\textsuperscript{1821} \textit{Pringle v Ireland} [116]. Beck (2014): otherwise, there would be no reason why Article 122(2) TFEU could not be used to safeguard the stability of the euro area as a whole, so far as its substantive conditions are met.
\textsuperscript{1822} \textit{Pringle v Ireland (View of AG Kokott)} [125].
\textsuperscript{1823} \textit{Lex specialis derogat legi generali}, Article 122 ‘cannot be dissociated from Article 125’: Merino (2012), 1633. See also: Borger (2013) 134 (Article 122(2) TFEU cannot be used unless the assistance does not \textit{also} amount to a bailout); and Boris Ryvkin, 'Saving the Euro: Tensions with the European Treaty Law in the European Union's Efforts to Protect the Common Currency' (2012) 45 Cornell Int'l LJ 227, at 238.
\textsuperscript{1824} See: \textit{Infra}, Chapter 2, Section 2.3.1.4 pp 133ff. Even stoic advocates of the narrow interpretation recognise a ‘consensus among legal scholars that Art122(2) establishes an \textit{exception} to the no-bailout clause’: Athanassiou (2011), 561. See also Merino (2012), 1633; Athanassiou (2011), 561 Louis (2010); Borger (2013), 119.
\textsuperscript{1825} Declaration No. 6. [Emphasis added]
\textsuperscript{1826} This reading is again confirmed by the Council in a written reply to Irish MEP Kathy Sinnott in 2009, which reaffirmed that financial assistance under Article 122(2) TFEU must be ‘compatible with the “no bailout” rule.’ Council of the EU, Question no 15 by Kathy Sinnott: Exceptional Circumstances (7 May 2009) H-0237/09.
\textsuperscript{1827} Borger (2013) 134.
\end{flushright}
‘overdraft facilities or any other type of credit facility’), Article 125 cannot be intended to prohibit ‘any financial assistance whatever.’

But clearly Article 125 should not, and could not, be drafted in the terms of Article 123. Only with the greatest logical contortion can the narrow interpretation be justified on the basis of bespoke terminology between the two provisions. The ECB has financial instruments available to it which Member States do not, and the Member States engage in redistributive activities which the ECB does not. So, for example, Article 125 TFEU could not prohibit Member States from adopting ‘any other credit facility’ or ‘any claim against the public sector’, because, under Reg 3603/93, that prohibits financing ‘any undertaking over which the State or other regional local authorities may directly or indirectly exercise a dominant influence by virtue of their ownership of it, their financial participation therein, or the rules that govern it.’ One need not be particularly imaginative to see that this would prohibit dealings with innumerable state-funded enterprises at national level and many of the reallocate financing operations of the Union, such as infrastructure projects and regional policy.

As shown in Chapter 2, both provisions are drafted as broadly as they can be in order to meet a single danger from two qualitatively different sources: Access to non-market finance.

6.4.3 The Teleological Interpretation of Article 125 TFEU

Having concluded that Article 125 TFEU stands for the proposition that financial assistance is permitted in some (unspecified) circumstances, but in other (unspecified) circumstances it is not so, the court moved on to a teleological examination to determine what, exactly, this does and does not preclude. In that regard, the court identified three teleological purposes underpinning Article 125 TFEU: Market discipline, budgetary discipline, and price stability. The ‘Pringle Hypothesis’ is that financial assistance will comply with these teleological requirements (which are in turn assimilated to compliance with the Treaty) where three conditions are met:

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1828 Pringle v Ireland [132]. In support of this view, see: Merino (2012), 1627; Athanassiou (2011), 562.
1829 As Borger (2013), 134 consists: ‘As the wording… is so much focused on the specific nature of central banks and their position before the launch of EMU it cannot provide strong guidance on the interpretation of Article 125 TFEU.’ See also: Bardutzky and Fahey (2014), 356: ‘In our opinion, to use the nuanced difference between the texts of the provisions … as grounds for such a weighty interpretation hints at the possibility that the Court was acting in a result-oriented manner.’
1830 Borger (2013), 134 (noting that Article 123 had the specific purpose of targeting certain credit arrangements in place for public authorities prior to EMU).
1831 Arts 3, 8(1) Reg 3603/03
1832 The exception in Art 125 for the ‘joint execution for a specific project’ would also not be sufficient to discharge this problem, since many of the EU’s reallocative funds are general budgets for a range of non-specific projects.
1833 Recited in full, infra, Section 6, p 218. Pringle v Ireland [136]: the Treaty prevents the granting of ‘financial assistance as a result of which the incentive of the recipient Member State to conduct a sound budgetary policy is diminished.’
First, to ‘ensure that the Member States remain subject to the logic of the market when they enter into debt,’ financial assistance may only be given where the recipient Member State ‘remains responsible for its commitments to its creditors.’

Second, to fulfil the precept of budgetary discipline, financial assistance must be attached to strict conditionality and will be lawful only ‘provided that the conditions attached to such assistance are such as to prompt that Member State to implement a sound budgetary policy.’

Third, to safeguard the ‘higher objective’ of the financial stability of the monetary union, financial assistance may only be granted \textit{ultima ratio}, ‘when such support is indispensable to safeguard the financial stability of the euro area as a whole and of its Member States.’

Under these conditions, the ECJ held that the ESM complied with the teleology of Article 125 TFEU, and therefore was lawful.

It is one thing, however, for an instrument to be ‘rooted in the idea of budgetary discipline’ and quite another for an instrument to actually achieve it. It is a yet further thing that the instrument not have been explicitly excluded by the Treaty drafters for that task, even if it is theoretically competent. The issue is not only whether the ESM ‘diminishes the incentive for national financial probity and hence falls within the prohibition in Article 125’ as a matter of fact (examined in Chapter 7), but whether the legal conditions set out by the courts are in fact consistent with the teleology of the \textit{Treaty drafter’s} choice of instrument.

This section finds, remarkably, that the instruments of the ESM issued since \textit{Pringle} do not comply with the formal conditions laid down by the court, and the conditions laid down by the court do not, in turn, comport with the teleologies they are intended to subscribe.

\textbf{6.4.3.1 Inconsistency with Market Discipline}

First, \textit{Pringle v Ireland} states that Member States must remain subject to the ‘logic of the markets when they enter into debt.’ It is unfortunate, then, that the court offers no account of how the

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1834 \textit{Pringle v Ireland} [137]-[139]: ‘[A]rts 14–18 of the TESM demonstrate that the ESM will not act as guarantor of the debts of the recipient Member State. The latter will remain responsible to its creditors for its financial commitments.’

1835 \textit{Pringle v Ireland} [135]-[137], [143] ‘It is apparent ... that the purpose of the strict conditionality to which all stability support provided by the ESM is subject is to ensure that the ESM and the recipient Member States comply with measures adopted by the Union in particular in the area of the co-ordination of Member States’ economic policies, those measures being designed, inter alia, to ensure that the Member States pursue a sound budgetary policy.’

1836 \textit{Pringle v Ireland} [142]-[145]. In that regard: ‘[T]he TESM does not provide that stability support will be granted as soon as a Member State whose currency is the euro is experiencing difficulties in obtaining financing on the market. ... [S]tability support may be granted ... only when such support is indispensable to safeguard the financial stability of the euro area as a whole and of its Member States’

1837 \textit{Pringle v Ireland} [137].

1838 Merino (2012), 1645.

1839 \textit{Pringle v Ireland} [135], [137]-[139]. This has been a legal condition of every financial assistance instrument launched so far. The justification for the first intra-EU bailout, for example, stated: ‘The objective of this mechanism will not be to provide financing at average euro area interest rates, but to set incentives to return to market financing as soon
requirement that the recipient Member State ‘remains responsible for its commitments to its creditors’ coheres with that teleology.\textsuperscript{1840} AG Kokott does, however, make an attempt to fill this lacuna, and this is expressed as follows:

‘Direct support of the creditors is prohibited, while indirect support, which arises as a result of the support to the debtor Member State, is not prohibited. The creditors of a Member State will therefore as a rule benefit from support given to that Member State. There remains however for the potential creditors of a Member State an additional uncertainty as to whether possible financial assistance to a Member State may actually lead to the satisfaction of their demands. To that extent, the voluntary support of a Member State need not inevitably be accompanied by either a complete or even partial satisfaction of the Member State’s creditors.’\textsuperscript{1841}

Setting aside the problem that this appears inconsistent on its face (if creditors will ‘as a rule’ benefit from support given to a debtor, then it is inevitably accompanied by a partial satisfaction of those creditors), it depends on the specious conclusion that in so far as the recipient Member State ‘remains responsible for its commitments to its creditors,’ the ‘logic of the markets’ is preserved.\textsuperscript{1842} In the view of the court, it matters not that the Member States commit ‘irrevocably and unconditionally’ to fund each other’s liabilities.\textsuperscript{1843} All that matters is that the initial contractual liability is not formally reassigned. As shown in Section 6.4.1.2, it imagines a ‘logic of the markets’ in which no trades occur unless the investment is entirely under-written through specific forms of indemnity. Since this is not done, the ‘logic of the markets’ is preserved.

This description of ‘market logic’ would surely earn a flunking-grade on a sixth-form exam.\textsuperscript{1844} Perhaps most obviously, since a creditor can never truly know if a debtor will use new resources to pay off a debt, if bailouts did not improve the creditworthiness of a borrower, no other revenues (such as taxes, etc.) would either. But of course they do.\textsuperscript{1845} For the purposes of market discipline, it does not matter whether financial assistance is provided directly or indirectly.\textsuperscript{1846} Ratings agencies

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\textsuperscript{1840} As Borger (2013), 136: ‘the Court did not address the relationship between the ESM and market discipline at all.’

\textsuperscript{1841} Pringle v Ireland (View of AG Kokott), 148, 151-152.

\textsuperscript{1842} Pringle v Ireland [137].

\textsuperscript{1843} As Beck (2014), 239 protests, Pringle v Ireland depends upon ‘a contestable purposive reading of the “market logic” underlying [Article 125], which ignores the disincentives and contagion risk flowing from “socialising” the debts of individual Member States.’


\textsuperscript{1845} Thomas J Courchene, ‘Subnational Budgetary and Stabilization Policies in Canada and Australia’ in James M Poterba and Jürgen Von Hagen (eds), Fiscal Institutions and Fiscal Performance (University of Chicago Press 1999) 301, 344.
such as S&P’s, for example, essentially view fiscal transfers as own-source revenues. As will be shown in Chapter 7, several German Länder provide notable examples of governments who are no longer subject to the ‘logic of the markets’ due to what creditors believe is ‘a rather straightforward guarantee of subnational debt.’1847 This is so despite the fact that Germany’s ‘straightforward guarantee’ – written in constitutional law - would not be caught by the Pringle test: German transfers are provided to Länder governments, not their creditors. Craig explains:

‘[I]t is easy, given the complexity of this area, to lose sight of the fundamental thread that underpins the ESM: the assistance is provided on terms or in circumstances that would not be provided by the ordinary markets. That is the very raison d’être of the ESM. There is in that sense a real tension between the purpose underlying Article 125 and the interpretive realization by the Court.’1848

It must be recalled that, according to the 1989 Monetary Committee, the purpose of 125 TFEU is to ‘ensure that the financial markets ... discipline unsound budgetary policies by imposing differential terms on its paper and ultimately by refusing to lend.’1849 Yet thwarting this objective is written explicitly into the financial instruments of the TESM: ESM Loans are provided ‘where a Member States has lost access to market financing’ because lenders will only provide financing ‘at excessive prices that would adversely impact the sustainability of public finances,’1850 and ‘the main objective of the PMSF shall be to allow the ESM Members to maintain or restore their market access.’1851 Similarly, the objective of the SMSF is to provide financing where ‘the lack of market liquidity threatens financial stability.’1852 In other words, many of the ESM’s instruments provide financing exclusively in situations which the ‘logic of the markets’ would prohibit.

In any event, as a matter of fiscal federalism, it is sufficient to note that, as remarked by the IMF,1853 the Bundesbank,1854 and Sections 6.1.1-6.1.3 of this thesis, this condition is not in fact met. Interest rates on EFSM/EFSF/ESM programmes have been fixed ‘well below market level’ and, as the Bundesbank finds, ‘future incentives for sound public finances were [in fact] weakened.’1855 As shown in Sections 6.1.1-6.1.3 The first bailout (to Greece) was set at a floating rate of (3-month

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1849 Monetary Committee, EMU Beyond Stage I (1990).
1850 Art 15 TESM; Art 1 ESM Guideline on Loans (ESM 2014)
1851 Arts 17(1) TESM. Art 1, ESM Guideline on the PMSF
1852 Art 1 ESM Guideline on the SMSF Most acutely, the PCCL and ECCL ‘secure the possibility to access ESM assistance before they face major difficulties raising funds in the capital markets’, thereby helping ESM Members to ‘maintain continuous access to market financing’ by ‘ensuring an adequate safety-net.’ In that situation, a Member State is no longer subject to the logic of the markets at all – debt mutualisation insulates Member States from market discipline before it can even be brought to bear. See; Art 1 ESM Guideline on the PCCL and ECCL.
1854 Deutsche Bundesbank (2011), 63.
1855 Deutsche Bundesbank (2011), 63
Euribor rate + 300bps for the first three years, and 3-month Euribor + 400bps thereafter).\textsuperscript{1856} The second bailout (to Ireland) was set at (cost + 292.5bps), with a maximum maturity of 7.5 years.\textsuperscript{1857} The third bailout (to Portugal) was set at (cost + 215bps) with a maximum average maturity of 7.5 years.\textsuperscript{1858} By October 2011, a succession of nearly two dozen amendments had reduced the price of EFSM loans to cost, while the average maximum maturity was extended - first to 12.5 years (October 2011), then to 19.5 years (June 2013).\textsuperscript{1859} In July 2015, when Greece was found ineligible to access €7.2bn in its bailout programme, it was not cut off. Rather, the EFSM gave it €7.16bn bridge loan at cost + 10bps.\textsuperscript{1860} Its bailout programme has now been amortised to 2058, and debt relief seems in the offing.\textsuperscript{1861} By 2012, ESM bailouts to Spain and Cyprus were going for between -0.06 and -0.21% of EURIBOR.\textsuperscript{1862} This is not market pricing. The Member States received a discount \textit{below the base rate}, ‘contradicting both IMF standards and practice.’\textsuperscript{1863} In an environment of negative interest rates, this is free money - at a cost to the lender(!). The \textit{Bundesbank} complains:

‘This weakens the foundations of monetary union, which is based on the principles of national fiscal responsibility and the disciplining effect of capital markets… assuming the rules continue to be breached, protection from the capital market is ultimately granted at extremely beneficial conditions that were even much more favourable than those for some countries providing assistance.’\textsuperscript{1864}

\textbf{6.4.3.2 Inconsistency with Budgetary Discipline}

Second, order to fulfil the teleology of budgetary discipline, financial assistance is lawful \textit{‘provided that the conditions attached to such assistance are \textit{such as to prompt} that Member State to \textit{implement} a sound budgetary policy.’}\textsuperscript{1865} The legality of the ESM is therefore dependent upon the claim that financial conditionality is just as competent to preserving the precept of fiscal discipline as hard budget constraints and market discipline under the Treaty.\textsuperscript{1866}

\begin{footnotesize}
\begin{itemize}
\item\textsuperscript{1856} Plus an up-front service fee of 50bps. European Commission, ‘Adjustment Programme for Greece’ (2010), 26.
\item\textsuperscript{1857} Arts 1(5)-(6), Council Implementing Decision 2011/77/EU; IMF, Ireland: Letter of Intent (3 December 2010).
\item\textsuperscript{1858} Art 1(5) Council Implementing Decision 2011/334/EU
\item\textsuperscript{1859} The Irish implementing decision has been amended nine times, and the Portuguese implementing decision amended eleven times. For Ireland: Council Implementing Decision 2011/682/EU; Council Implementing Decision 2013/313/EU. For Portugal: Council Implementing Decision 2011/683/EU; Council Implementing Decision 2013/323/EU.
\item\textsuperscript{1860} Council of the EU, ‘Council approves €7bn bridge loan to Greece’ (2015); Council Implementing Decision of 17 July 2015 on granting short-term Union financial assistance to Greece (NLE) 2015/0157; Economist, ‘Payback time’ (2015).
\item\textsuperscript{1862} ESM, ‘Issue of EURO 12,000,000,000 Floating Rate Notes due December 2015 under the Debt Issuance Programme’ (ESM, 7 December 2012) <http://www.esm.europa.eu/assistance/spain/index.htm> accessed 5 November 2015.
\item\textsuperscript{1863} Zeitler (2014), 248.
\item\textsuperscript{1864} Deutsche Bundesbank (2011) 64.
\item\textsuperscript{1865} \textit{Pringle v Ireland} [136]-[137].
\item\textsuperscript{1866} As Athanassiou (2011), 562 so puts it, if conditional financial assistance can ‘help Member States return to fiscal discipline (rather than default)’ then ‘the fiscal discipline objective [is] well served.’
\end{itemize}
\end{footnotesize}
Yet the ‘narrow’ interpretation of the ‘no bailout’ rule now arising in the court is uncannily reminiscent of Articles 4-4a of the Commission draft treaty that was roundly rejected by the technical committees and Member States at Maastricht in 1989-1990. The Commission proposal - ‘a specific financial support scheme which would be activated when major economic problems arose or when economic convergence calls for a particular Community effort … in the sense of positive conditionality’ – could be mistaken for a blueprint of the ESM. It possessed the same instruments; it fit into an overall system of governance which consisted of plurennial economic policy guidelines; it reinforced surveillance of economic and budgetary policy; and it contained a special financial support scheme subject to compliance with EU governance. Its main use, much like the PCCL, ECCL and PMSF and SMSF facilities under Articles 14 and 17-18 of the TESM would be to support economic adjustment strategies through conditionality.

First, like para 137 of Pringle v Ireland, Article 4 of the Commission draft treaty proposed narrowing the scope of the ‘no bailout’ rule to ‘the granting by the community or the Member States of an unconditional guarantee in respect of the public debt of a Member State.’ Second, like paras 136-137 of Pringle, the Commission draft treaty stated that, ‘subject to certain conditions, the Member State concerned may be granted […] financial assistance which may take the form of a support programme accompanied by budgetary intervention or special loans.’ Third, like the ultima ratio condition in paras 96 and 142 of Pringle, the Commission draft Treaty stated that financial assistance could only be given where ‘a Member State is in difficulties or is seriously threatened with difficulties.’

As shown in Section 2.3.1.4, this interpretation of the ‘no bailout’ principle was rejected by the technical committees in 1989-1990, excluded from the mandates for the IGC by the European Council in Rome, and again rejected (derisively) when it was surreptitiously re-introduced by the

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1867 See Section 2.3.1.4, p 133. For the proposal: Commission of the EC, 'Contributions by the Commission' (1990). For criticism: Monetary Committee, EMU Beyond Stage I (1990), 2; Committee of Governors, Report of 26 March 1990 (1990), 2; Padoa-Schioppa, The Road to Monetary Union (1994) 174, observing, that it was seen as 'essential that traps of this sort be avoided in the design of the European Monetary Union.'

1868 Commission of the EC, 'Contributions by the Commission' (1990), 15. See: Infra, Section 2.3.1.4 p 133.

1869 Commission of the EC, 'Contributions by the Commission' (1990), 21.

1870 Art 104a EC of the Commission Draft Treaty: Commission of the EC, 'Contributions by the Commission' (1990), 43 [emphasis added]. Cf: Pringle v Ireland [138]-[139] financial assistance is lawful as long as ‘the ESM will not act as guarantor of the debts of the recipient Member State.’

1871 Art 104 EC of the Commission draft Treaty: Commission of the EC, 'Contributions by the Commission' (1990), 42. 'Where a Member State is in difficulties or is seriously threatened with difficulties, the Commission may proposed to the Council, which shall act by a qualified majority, that, subject to certain conditions, the Member State concerned be granted Community financial assistance which may take the form of a support programme accompanied by budgetary intervention or special loans.' Cf: Pringle v Ireland [136]-[137] holding that Article 125 TFEU does not prohibit financial assistance in the form of budgetary intervention or special loans in so far as they are subject to financial conditionality.

1872 Art 104 EC of the Commission draft Treaty: Commission of the EC, 'Contributions by the Commission' (1990), 42. Cf: Pringle v Ireland [96]-[142]: financial assistance may only be given where Member States ‘are experiencing or are threatened by severe financing problems’ or if ‘indispensable for the financial stability of the euro area as a whole.’
Commission at Maastricht. Instead, Article 108 EC itself – which had provided for balance of payments assistance since 1957 - was written out of the design of EMU. Other avenues for conditional financial assistance now possessed by the ESM, such as bond purchases, were also closed at Maastricht: Reg 3603/93 for example, only allows primary purchases of bonds of Member States which are not part of the Euro.

Put simply, Pringle v Ireland has christened into reality, with remarkable faithfulness, the very mechanism which was so roundly by condemned by the Treaty drafters as a matter of history and practice for the purpose of budgetary discipline.

Indeed, all of the predictions of the Treaty drafters recited in Section 2.2.4 have now come to pass: Country conditionality is watered down by politics and ‘secret deals,’ including by interventions by the Commission, and Commission meeting minutes enunciate a ‘political approach’ to applying EU fiscal rules. Where recipients of conditionality fail to meet terms, conditionality is continually watered down. The cost of financial assistance has fallen from EURIBOR + 400bps and a maturity of 7.5 years; to EURIBOR - 21bps, with amortisations kicked to 2058. Where a country fails to comply with conditionality, it will not be cut off – it will receive a bridge loan a (cost + 10bps). IMF meeting minutes lament that, due to Commission interference, EU bailout conditions are not credible – disbursements will be made even if conditions are not met – and that this has, in fact, reduced the impetus to follow sound budgetary policy.

Worse if all of the above were untrue, the ESM itself does not even meet the formal terms set out by the ECJ in Pringle itself: Under several of the ESM’s financial instruments, there is no conditionality attached to financial assistance whatsoever. Under PCCL and the ECCL, the only conditions to be met are the normal criteria for economic stability and compliance with the European Semester, and even then, Articles 2(a)-(c) and 2(4) make clear that an ‘An ESM member under excessive

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1873 See Section 2.3.1.4, p 133.
1874 Art 2(2) Reg 3603/03
1875 Borger (2013), 139 notes that the court is ‘play[ing] a little with history.’ See: Chapter 2, Section 2.3.1.4, pp 107 ff.
1876 The Commission President recently the application of the treaty rules to France’s dozeenth violation of the SGP since 1999 ‘because it is France.' Francesco Guarascio, 'EU gives budget leeway to France "because it is france"' - Juncker’ Reuters (Brussels 31 May 2016) <http://www.reuters.com/article/eu-deficit-france-id> accessed 31 May 2016.
1877 European Commission, Minutes of the 211th meeting of the Commission held in Strasbourg (Winston Churchill) on Tuesday 13 January 2015 PV(2015) 2111 final (2015), 18. EEAG, (2011), 94. See also: Groeteke and Mause (2012), 287 finding 82 violations in 204 possible cases (i.e. 40% of breaches) where the rules were not applied.
1878 ESM, 'ESM Programme for Greece: Repayment Schedule' (2014); ESM, 'Issue of EURO 12,000,000,000' (2014).
1880 See: Meeting minutes between the head of the IMF’s European Department (Poul Poulisen) and the IMF’s Mission to Greece (Delia Velkouleskou), excerpted as follows: ‘THOMSON: They [Greece] are not on track to meet the criteria. That is the whole point. Right? VELKOULESKOU: Yeah, that’s right. […] I think actually politically for them [the Greeks] it is possible to give on both of these things [conditionality]. But they don’t have any incentive [to agree conditionality] and they know that the Commission is willing to compromise, so that is the problem.’ [square brackets added]. Velkouleskou, Thomsen and Petrova (2014).
1881 Article 2 of the ESM Guideline on the PCCL and ECCL states that only substantive conditions for access to a PCCL (aside from a generally ‘sound’ financial position) are the ordinary requirements of compliance with the SGP and EIP.
deficit procedure/EIP may still access a PCCL\textsuperscript{1882} and an ECCL ‘shall be open to ESM Members that do not comply with some of the eligibility criteria.’\textsuperscript{1883} The SMSF is even worse – it applies without any financial conditionality at all: it ‘may be open to an ESM Member outside of a macro-economic adjustment programme.’\textsuperscript{1884} Article 7(12) of Reg 472/2013 –the EU obligation to apply conditionality to financial assistance – admits this openly:

‘This Article shall not apply to instruments providing financial assistance on a precautionary basis, to loans made for the recapitalisation of financial institutions, or to any new ESM financial instrument for which the ESM rules do not provide for a macroeconomic adjustment programme.’\textsuperscript{1885}

Whether one adopts a substantive or a formal reading, this would appear, \textit{prima facie}, to violate the express conditions of Article 136(3) TFEU. Financial assistance may be issued with no more - and certainly no stricter - conditionality than ordinarily applies to Member States which receive no financial assistance whatsoever. This does not meet the \textit{Pringle} test, whether one looks to its substance or its thinnest formal lines.

\textbf{6.4.3.3 Inconsistency with Price Stability}

The third condition set out in \textit{Pringle v Ireland} is an \textit{ultima ratio} one: ‘Given that [budgetary discipline] is the objective pursued by Art125 TFEU, it must be held that […] the activation of financial assistance is not compatible with Art125 TFEU unless it is indispensible for the financial stability of the euro area as a whole.’\textsuperscript{1886}

Curiously, there is no textual basis in the Treaty for this condition. Instead, this \textit{ultima ratio} reasoning implies that, where financial assistance is indispensible for the stability of the euro area, an act which would normally compromise fiscal discipline suddenly does not. Athanassiu, a proponent of this interpretation, explains that the logic of the ‘no bailout’ rule is ‘suspended’ during a threat to sovereign solvency:-

\textsuperscript{1882} Art 2(2)(a) states: ‘An ESM Member under excessive deficit procedure may still access a PCCL, provided it fully abides by the Council decisions and recommendations aimed at ensuring a smooth and accelerated correction of its excessive deficit. Art 2(2)(c) states: ‘An ESM Member under EIP may still access a PCCL, provided it is established that it remains committed to addressing the imbalances identified by the Council.’ ESM Guideline on the PCCL and ECCL

\textsuperscript{1883} Art 2(4) ESM Guideline on the PCCL and ECCL.

\textsuperscript{1884} Art 2(2) ESM Guideline on the SMSF.

\textsuperscript{1885} Art 7(12) Reg 472/2013.

\textsuperscript{1886} \textit{Pringle v Ireland} [136]. This condition is notionally internalised in Article 12(1) TESM, which states: ‘If indispensible to safeguard the financial stability of the euro area as a whole and of its Member States, the ESM may provide stability support to an ESM Member subject to strict conditionality, appropriate to the financial assistance instrument chosen.’
‘In such a case, the disciplinary effect of financial markets on an over-indebted Member State would no longer be conducive to its timely return to budgetary restraint - as per the assumption underlying the no-bailout clause - but, instead, to its default.’\textsuperscript{1887}

But this makes little sense. If Article 125 TFEU only applies up until the moment that some final, marginal decision pushes a country’s liabilities over the edge of sustainability, the failure to conduct prudent policy would lead, in every case, to the mutualisation for the liabilities accrued. If the prospect of default is eliminated in every case, so also is the impetus for budgetary discipline. It is only in such circumstances that the prohibition on assistance has a function, since it is only the possibility of default which causes interest rates to rise.\textsuperscript{1888} Palmstorfer explains:

‘It can be assumed that the typical situation the drafters had in mind was exactly the Greek one. A Member State cannot refinance itself on the markets, because of the existence of considerable public debts. ... Only at this stage, that is, after it has piled up too much debt, could it be expected to turn to the European Union or its Member States for help. And if it receives such help—be it in the form of guarantees or in the form of loans—it would use this assistance to pay back its debts.’\textsuperscript{1889}

In any event, once again, the ESM does not meet the formal condition set out by the court. Several ESM instruments provide assistance specifically where it is not ultima ratio, ‘indispensable for the stability of the euro area.’ The objective of the precautionary facilities is to ‘support sound policies and prevent crisis situations’ by allowing ESM Members ‘access to ESM assistance before they face major difficulties raising funds in the capital markets.’\textsuperscript{1890} It is ‘to maintain continuous access to market financing by reinforcing the credibility of their macroeconomic performance while ensuring an adequate safety-net.’\textsuperscript{1891} Under both precautionary assistance and the SMSF, financial assistance can only be activated, inter alia, when the Member State has sustainable debt, a track record of access to capital markets on reasonable terms, where the economic and financial situation is still fundamentally sound’ and where there is an absence of bank solvency problems that would ‘pose systemic threats to the stability of the euro area banking system.’\textsuperscript{1892} In short, these instruments may only be issued in circumstances in which they are not indispensable to safeguard the stability of the euro as a whole. As the Bundesbank complains:

\begin{itemize}
\item \textsuperscript{1887} Athanassiou (2011), 561-562.
\item \textsuperscript{1888} The e ultima ratio power ‘clearly contradicts arts 123, 125 and 127 TFEU, which each provide that there are certain measures the Union institutions are precluded from having recourse to under any circumstances.’ Beck (2014), 240.
\item \textsuperscript{1889} Palmstorfer (2012), 777.
\item \textsuperscript{1890} Art 1 ESM Guideline on the PCCL and ECCL.
\item \textsuperscript{1891} Art 1 ESM Guideline on the PCCL and ECCL.
\item \textsuperscript{1892} Art 2, ESM Guideline on the SMSF; Art 2(2) ESM Guideline on the PCCL and ECCL (emphasis added).
\end{itemize}
‘it is not clear how […] this can be brought into line with the requirement of granting aid only as a measure of last resort to avert a risk to the stability of the euro area as a whole.”

6.4.3.4 Inconsistency with the Narrow Interpretation

Finally, the last redoubt of the narrow interpretation of Article 125 TFEU is that the ‘no bailout’ rule is, in all circumstances, an absolute prohibition on guarantees where a Member State steps into the shoes of the debtor. This redoubt is not subject to an ultima ratio exception, it is not assuaged by any of the conditions set out above, and it remains intact even when the prohibition on loans dissolves.

Here, too, difficulties arise. As set out in Section 6.1.5, Article 25(2) TESM states that if one or more members fails to meet a capital call, a revised capital call will be made for which the remaining members will be jointly and automatically liable for the unpaid portion. This appears to establish joint and several liability for the unpaid portion of losses: If the ESM faces default because some Member States haven’t paid their share, under Article 25(2) TESM the others are committed, ‘irrevocably and unconditionally’ to fulfil that obligation within seven days.

The entire edifice of the narrow interpretation that financing the commitments an indebted Member State does not amount to a de jure assumption of liability in violation of Article 125 TFEU because the debtor Member State’s liabilities to third-party creditors are not transferred from the debtor country to the ESM when the ESM gives financial assistance to that country. But even this interpretation is not possible here. Article 25(3) TESM clearly states that when a delinquent Member State ‘settles its debt’ to the ESM, the capital ‘shall be returned to the other ESM Members’ – not the ESM. If the Member State doesn’t repay the ESM – it never has to under the Treaty. Its fellows do. It may ultimately repay those fellows or it may not, but its liability to the ESM is discharged. In the literal sense of the narrow interpretation of Article 125 TFEU, they ‘assume the commitments of’ the other Member State to the ESM and ‘become liable for’ their obligations to fund the ESM losses. This does not comply with the narrowest redoubt of the narrow interpretation.

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1894 See: The textual interpretation as a prohibition on guarantees, infra, Section 6.4.1.2; Pringle v Ireland [137].
1895 Art 25(2) TESM: ‘If an ESM Member fails to meet the required payment under a capital call made pursuant to Article 9(2) or (3), a revised increased capital call shall be made to all ESM Members with a view to ensuring that the ESM receives the total amount of paid-in capital needed.’
1896 Pringle v Ireland [144]-[146] ‘Thirdly, the national court refers to an argument of the applicant in the main proceedings that the rules relating to capital calls stated in art.25(2) of the ESM Treaty are incompatible with art.125 TFEU in that they imply that the ESM Members guarantee the debt of the defaulting member. […] However, under that same provision, the defaulting ESM Member State remains bound to pay its part of the capital. Accordingly, the other ESM Members do not act as guarantors of the debt of the defaulting ESM Member.’
1897 Art 35(3) TESM reads: ‘When an ESM Member settles its debt to the ESM, as referred to in paragraph 2, the excess capital shall be returned to the other ESM Members in accordance with rules to be adopted by the Board of Governors.’
6.5 Conclusion: The Failure of the Pringle Hypothesis as a Matter of Law

*Pringle v Ireland* supplants a legal pillar of decentralised fiscal federalism (an entrenched ‘no-bailout’ law) with a legal pillar of unitary states: A centralised fiscal capacity and legal governance of sub-federal economic and fiscal competences.\(^{1998}\) The justification for this surgery is the proposition referred to herein as the ‘Pringle Hypothesis’ - that financial assistance and legal governance is both contemplated by the existing Treaties and capable of replacing ‘the logic of the markets’ in fulfilling the precept of fiscal discipline.\(^{1999}\) In order for this hypothesis to be correct, it must be both factually correct (see Chapter 7) and correct as a matter of law - i.e., it must be *contemplated by the Treaty drafters* as competent to the logic of the markets and fiscal discipline. Were it not so, the constitutional conditions set by the court under 125 TFEU would not be met, and financial assistance would be unlawful under the Treaties.\(^{1900}\)

This chapter concludes that conditional financial assistance is simply not reconcilable with the legal architecture for fiscal discipline inscribed in the Treaties. This conclusion is extracted as follows:

[6.3] The new legal architecture of conditional financial assistance is fundamentally incompatible with the allocation of competences under the Treaties. There is but one avenue for financial assistance in the ‘Economic Policy’ Chapter of the Title VIII TFEU - Article 122(2) TFEU - and this is preclusive of any other mechanisms as a matter of law, whether Member State or EU competence. The Treaty drafters were acutely aware that they precluded all other avenues for financial assistance under the Treaty, and made this explicit throughout the preparatory work.\(^{1901}\) This section therefore concludes, as the BVerfGE does, that the ECJ’s interpretation of this framework simply cannot conceal the ‘overlap’ between the EFSM, EFSF, ESM and OMT.\(^{1902}\) In accordance with the hypothesis of this thesis, the application of these mechanism is now subject to the continuous acquiescence and supervision of national constitutional courts. Proof for this proposition is found in the *Gauweiler v Bundesbank* litigation, in which the BVerfGE rejected the *Pringle* Hypothesis, ruled that the ECB’s OMT programme *in fact* exceeded the competences of the Union, and placed six conditions on its operation (over which national institutions were placed in a position of


\(^{1999}\) As stated in both *Pringle v Ireland* and *Gauweiler v Bundesbank*, under Articles 123 and 125 TFEU, European fiscal federalism ‘prohibits the Union and the Member States from granting financial assistance as a result of which the incentive of the recipient Member State to conduct a sound budgetary policy is diminished.’ *Pringle v Ireland* [135] See also: *Gauweiler II (CJEU)* [100] ‘It is apparent from the preparatory work relating to the Treaty of Maastricht that the aim of Article 123 TFEU is to encourage the Member States to follow a sound budgetary policy, not allowing monetary financing of public deficits or privileged access by public authorities to the financial markets to lead to excessively high levels of debt or excessive Member State deficits.’

\(^{1998}\) See, e.g., *Gauweiler III (Germany)* [3](c) ‘Against this backdrop, one must assume that the Court of Justice considers the conditions it specified to be legally binding.’

\(^{1981}\) See Chapter 2, Section 2.3.1, pp 130-136.

\(^{1982}\) *Gauweiler III (Germany).*

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supervision). It is also visible in the string of rulings on the ESM before the German BVerfGE, the Irish Supreme Court, the Austrian VfGH, the Finnish Perustuslakivaliokunnan, the Policy Trybunał and the Estonian Riiikohus, which duly placed limits on the operation of the ESM under their own ‘constitutional identity’ jurisdictions - despite the ECJ recognising no such limits in Pringle v Ireland.

[6.4] The legal architecture of conditional financial assistance is fundamentally incompatible with Articles 122-125 TFEU. The conditions set out by the court for compliance with fiscal discipline do not comport with the teleologies they are meant to subscribe, and the ESM in turn does not comply with the formal conditions set out by the court: [6.4.1] The ‘narrow’ interpretation of Article 125 TFEU does not conform to basic canons of textual interpretation; [6.4.2] the narrow interpretation is incompatible with a systemic analysis of Articles 122-125 TFEU; and [6.4.3] the conditions set out by the ECJ hearken to an interpretation that was rejected by the technical committees in 1989-1990, excluded from the mandates for the IGC by the European Council in Rome, and again rejected by the drafters at Maastricht when it was surreptitiously re-introduced by the Commission in July 1990. Were none of that so, the instruments of the ESM do not, in turn, comply with any of the conditions set out by the court: Member States are not subject to the ‘logic of the markets’ when they enter into debt; the capital calls provisions do create a guarantee that discharges the liability of the debtor; financial assistance is not subject to conditionality; and it is given where it is not ‘indispensable for the stability of the euro area as a whole.’

This inability to reconcile the ESM and OMT with the allocation of competences and substantive provisions of Title VIII of the Treaty provides the first testable indication that the new model is incompatible with the constitutional fault lines running through it. This raises two further hypotheses tested in the following chapters of this thesis:

[7] That conditional financial assistance violates the essential legal preconditions indispensable to the mandate for stable prices, sound public finances and a sustainable balance of payments as a matter of economic fact; and,

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1903 Gauweiler III (Germany).
1904 Re ESM I (Germany); Re ESM II (Germany) [161]-[162].
1905 Spending obligations ‘must come from funds already committed by Ireland (with the approval of the Dáil).’ Pringle I (Ireland Supreme Court) [8.14] per Clark J.
1906 ESM (Austria) [104]-[105].
1907 Opinion 25/2011 on the ESM (Finland); Opinion 13/2012 on the ESM (Finland).
1908 ESM & TSGC (Poland), 305.
1909 ESM (Estonia) [105]-[106], [144].
1910 Monetary Committee, EMU Beyond Stage I (1990), 2; Committee of Governors, Report of 26 March 1990 (1990), 2; Padoa-Schioppa, The Road to Monetary Union (1994) 174, observing, that it was seen as ‘essential that traps of this sort be avoided in the design of the European Monetary Union.’
1911 Where the October summit lists the grounds of agreement for the preparatory work, conditional financial assistance was not among them: European Council, ‘Meeting of 27-28 October 1990 (Rome)’ (1990), 9 and Rome European Council, 14-15 December 1990.
[8] that the operation of the new legal architecture is now dependent on the good functioning of legal machineries which are outside the EU legal order, and thus dependent on continuous acquiescence by Member State courts under their ‘ultra vires’ and ‘constitutional identity’ jurisdictions.
7. Price Stability and Fiscal Discipline as a Matter of Economic Fact
7. The Pringle Hypothesis as a Matter of Economic Fact

The ‘Pringle Hypothesis’ upon which the nascent fiscal union is based holds that centralised legal governance can enforce budgetary discipline in a federated monetary union with an established bailout precedent and institutionalised financial assistance.1912 The hypothesis which has emerged from Part I of this thesis is the opposite: Hard budget constraints and market discipline are indispensable requirements for price stability and fiscal discipline in a federation bound by the fiscal sovereignty of its 28 constituent constitutional democracies.

This chapter tests that hypothesis, a posteriori, through empirical and theoretical analysis of the literature on fiscal federalism and public finance data. It must be recalled that, unlike other objectives of the Union, it is the actual attainment of price stability and fiscal discipline to which Member States and the Union are bound.1913 In Pringle v Ireland, the ECJ ruled that financial assistance is lawful ‘provided that the conditions attached to such assistance are such as to prompt that Member State to implement a sound budgetary policy.’1914 It should be noted that this is not an objectives-based test: The incentive to pursue a sound budgetary policy must actually be preserved. As stated by the BVerfGE in Brunner v EU Treaty:

‘This conception of the currency union as a community based on stability is the basis and subject-matter of the German Act of Accession. If the monetary union should not be able to develop on a continuing basis the stability present at the beginning of the third stage within the meaning of the agreed mandate for stabilization, it would be abandoning the Treaty conception.’1915

Here, however, it is not so much that an incremental breach of the Stabilitätsgemeinschaft is manifestly incompatible with the European legal order and will entail a declaration of invalidity or withdrawal from EMU. Rather, it is that systems which fail to adhere to these conditions are manifestly incompatible with the European legal order.1916 In particular, the BVerfGE has held that the ‘no bailout rule’ and ‘no monetary financing rules’ safeguard the Bundestag’s ‘national

1912 Pringle v Ireland [136]-[137] ‘Given that [budgetary discipline] is the objective pursued by art.125 TFEU, it must be held that that provision prohibits the Union and the Member States from granting financial assistance as a result of which the incentive of the recipient Member State to conduct a sound budgetary policy is diminished. […] art.125 TFEU does not prohibit the granting of financial assistance [to] a Member State which remains responsible for its commitments to its creditors provided that the conditions attached to such assistance are such as to prompt that Member State to implement a sound budgetary policy.’ (Emphasis added). See also Gauweiler III (Germany) [3](c) ‘Against this backdrop, one must assume that the Court of Justice considers the conditions it specified to be legally binding.’
1913 Brunner (Germany) [86], [89]-[90] ‘the Union Treaty governs the monetary union as a community which is permanently obliged to maintain stability and, in particular, to guarantee the stability of the value of the currency.’ See also: Commission, ‘Towards a Stability Pact’II/011/96-EN, 10 January 1996, 9.
1914 Pringle v Ireland [137].
1915 Brunner (Germany) [86], [89], [90]. See also: Re ESM I (Germany) [203].
1916 So, for example, as a matter of fiscal federalism theory, a failure to achieve budgetary discipline means inflation, debt mutualisation or centralized legal governance, and this offends the right to property (Article 14 BL) and the right to vote (Article 38 BL) which are part of the constitutional identity in conjunction with Article 1 BL (Human Dignity) and Article 20 BL (the Democratic State) and are not amendable under Article 79(3) BL. Brunner (Germany) [56].
budgetary responsibility’, and Germany’s constitutional identity would be violated if the Stabilitätsgemeinschaft should become a ‘liability community’ through the ‘direct or indirect communitarisation of state debts.’¹⁹¹⁷

This chapter applies established principles of fiscal federalism theory and evaluates empirical data from five federations in order to determine whether centralised legal rules can indeed ‘work’ to ensure the constitutional requirements of price stability and fiscal discipline in the European monetary union. It proceeds in two parts:

The first half of this chapter, Section 7.1, reviews the literature on fiscal federalism in order to extract the legal determinants of certain empirical facts known to public economics. Specifically, the essence of the Pringle Hypothesis’ is that a central fiscal capacity to finance debt in the Member States is compatible with the condition of fiscal discipline and, hence, price stability, so long as it is accompanied by centralised governance of economic policies. Section 7.1 analyses the literature to identify whether, and if so under what circumstances, this assumption may hold. The literature examining that question is extensive. The various strands of fiscal federalism theory have sought to identify the institutional precepts for public sector stability, as well as the various ‘pathologies of federalism’ which undermine it.¹⁹¹⁸ The ‘race to the bottom,’¹⁹¹⁹ the bailout hazard or ‘soft budget constraints,’¹⁹²⁰ the ‘flypaper effect’ of fiscal transfers,¹⁹²¹ and electoral ‘wars of attrition’ over structural reforms are all pathologies whose underlying incentive structures are well understood.¹⁹²² The literature also yields some rather certain lessons on how to avoid them. As Blume and Voigt observe:

¹⁹¹⁷ Re ESM I (Germany) [203]; Re ESM II (Germany) [167]-[171]; Aid Measures for Greece (Germany) [129], [137]; Gauweiler I (Germany) [41].
¹⁹²⁰ For surveys: Jonathan Rodden, Gunnar S Eskeland and Jennie Litvack (eds), Decentralization and the Challenge of Hard Budget Constraints (MIT Press 2003); Rodden, 'Fiscal Discipline in Federations' (2006); Wibbels (2003).
‘Summarising the available empirical evidence, it seems fair to say that we know quite a bit about the effects of substantive rules within (federal) states… The literature on the fiscal effects of fiscal institutions is well established, as is the underlying theory.’

The primary conclusion derived from Section 7.1 is that fiscal rules are of secondary importance to the institutional framework in which they sit. According to the IMF, rules adopted ‘without the prerequisites adequately in place are unlikely to be sustained and may end up undermining policy credibility.’ Eyraud and Sirera warn that debt brakes ‘are not a panacea,’ and Ter-Minassian concludes that ‘fiscal rules cannot substitute for a properly designed system of intergovernmental relations.’ Numerous studies reach similar findings. Fiscal rules can only ever be an adjunct to a well-functioning system of fiscal federalism – they cannot replace it (and may easily ruin it). Drawing together the various strands of the literature, Section 7.1 yields a roster of five institutional preconditions for legal governance to ‘work’ in a federal system: [7.1.1] Market discipline; [7.1.2] Hard budget constraints under a ‘no bailout’ rule; [7.1.3] Fiscal symmetry; [7.1.4] Expenditure and revenue autonomy; and [7.1.5] credibly designed fiscal rules.

Each will be examined in turn, however it should be noted that these five criteria are the same integral preconditions which emerge from the fiscal federalism literature generally as necessary for the ‘ideal type’ of federalism to exist in the first place. The clear implication is that fiscal rules do not make much difference to the overall incentive structure of a federation. Centralised legal governance is only effective if all the other institutional preconditions for fiscal discipline in a federal monetary union are already in place, and then only if the legal rule itself does not introduce its own pathologies into the federalism framework. History is littered with examples of federations where centralised legal governance could not hold due to other ‘flaws inherent in the decentralisation framework.’

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1926 ‘Empirical work on fiscal rules at the general level of government across European countries has established that their effectiveness depends on the institutional and political background of the respective country’: Dirk Foremny, ‘Sub-national deficits in European countries: The impact of fiscal rules and tax autonomy’ (2014) 34 Europ J Polit Economy 86, 89. See also: Mark Hallerberg, Rolf Strauch, Jürgen Von Hagen, 'The design of fiscal rules and forms of governance in European Union countries' (2007) 23 Eur J Polit Econ 338; Sutherland, Price and Joumard (2005); C Randall Henning, Martin Kessler, 'Fiscal Federalism: US History for Architects of Europe’s Fiscal Union' (Bruegel Lecture Series, 2012), 4; and R Daniel Kelemen, Terence K Teo, 'Law, Focal Points, and Fiscal Discipline in the United States and the European Union' (2014) 108 Am Polit Sci Rev 355, 357: ‘Fiscal prudence is less a function of fiscal rules than specific-country characteristics, such as political institutions.’
1927 For similar catalogues, see: Ter-Minassian (2007), 6; Groeteke and Mause (2012), 281.
Importantly, centralised fiscal rules are not capable of replacing market discipline in a decentralised federation.\textsuperscript{1930} History cautions that centralised debt brakes never work in a decentralised fiscal federation without market discipline,\textsuperscript{1931} and legal rules themselves ‘are neither necessary nor sufficient to ensure fiscal discipline at the subnational level.’\textsuperscript{1932} While history bears many successful examples of pure market discipline, or (fiscal rules + market discipline), there are no successful examples of fiscal rules without market discipline.

Section 7.2 applies those prescriptions to a comparative analysis of the EMU against of four advanced federations: The Federal Republic of Germany, the Swiss Confederation, the United States of America, and Canada. The federations are chosen for this analysis because they are the four oldest federations in the world, and the most appropriate to the European Union according to both a ‘most similar cases’ and a ‘prototypical cases’ methodology.\textsuperscript{1933} The analysis finds that the principles extracted from Section 7.1 are robust theoretical and empirical determinants of fiscal discipline. The conclusion of this chapter is that, as a matter of theory and evidence, the ‘Pringle Hypothesis’ is a theoretical and empirical failure. The new model has not reduced sovereign debt; it has not improved implementation rates of EU policy recommendations; and it has not applied on its own terms. The emergent European ‘fiscal union’ has institutionalised the dysfunctional economic incentives identified in Chapter 3 to be the \textit{causa sine qua non} of the sovereign debt crisis.\textsuperscript{1934}

7.1 Principles of Fiscal Federalism: Preconditions for Fiscal Discipline

Fiscal federalism theory may be divided into two generations. First Generation Fiscal Federalism (FGFF) theory is concerned with how to efficiently allocate tax and spending functions to different levels of government.\textsuperscript{1935} This includes the question of how to design fiscal transfers and whether, and at what level, financial resources should be ‘pooled’ in order to internalise spillovers from spending decisions. FGFF is based around Oates’ ‘Decentralisation Theorem,’ which posits that, unless there are offsetting economies of scale, a decentralisation of public outputs is typically more

\textsuperscript{1930} Chalmers (2012), 671; De Stree1 (2014), 97; Tommasi and Weischelbaum (2007).
\textsuperscript{1931} See, e.g., Foremny (2014): ‘O]nly deficits in unitary countries can be avoided by tying the government’s hands with fiscal rules, while they are ineffective in federations.’
\textsuperscript{1933} A ‘most similar cases’ methodology implies that these federations provide useful control factors for the main variables not central to this study, but differ in the terms of the object of this study. A ‘prototypical cases’ methodology implies that their different institutional patterns are prototypical of the two models of European fiscal federalism examined in this thesis: The decentralised Maastricht Model and the centralised new model. Hirschl (2005). See also: Baskaran (2011) (identifying two types of federations - ‘competitive’ and ‘cooperative’ federations).
welfare-enhancing than a centralised allocation of outputs.\footnote{Under the EU treaties, this is enshrined as the principle of subsidiarity: Art 5 TEU. Related to this benefit is the concept of competitive or ‘laboratory’ federalism, under which sub-federal jurisdictions are free to carry out public-sector experiments which, if successful, can then be copied by neighbouring jurisdictions. Oates, \textit{Fiscal Federalism} (1972).} The Decentralisation Theorem is based on two findings. First, in a variant of the principal-agent problem, the central government is subject to significant information asymmetries.\footnote{It is more costly for a central government to obtain information necessary to efficiently customise local outputs to local preferences and constraints: Oates, \textit{Fiscal Federalism} (1972); Oates, ‘Towards a Second-Generation’ (2005); Oates, ‘Evolution of Fiscal Federalism’ (2008). Cf. Cremer, Estache and Seabright (1996) (noting that there is no reason why, in principle, a central authority could not overcome this asymmetry by gathering and responding to local information, though it is less valuable to a central government).} This problem was shown to be at the root of the failure of the MSP in Section 3.2.4 of this thesis, where the Union was unable to perceive (or respond to) information about the character of interest-rate adjustment at local level.\footnote{A central government may be forced to inefficiently overspend on a public good in a constituency where it is not needed because not doing so would be ‘unfair’, or inefficiently underspend where it is needed due to other groups in the political process: Oates, \textit{Fiscal Federalism} (1972), 35. As Mawell and MacG so put it during the formative years of Canadian federalism: ‘The policies of the federal government will, to a much greater degree than those of the government of a unitary country, bring an uneven incidence of benefit or injury to the members.’ JA Maxwell, DA MacG, ‘The Adjustment of Federal-Provincial Financial Relations’ (1936) 2 Can J Econ Poli Sci 374, 383. In Canada, this is known as the ‘tyranny of the majority.’ See the literature surveyed in Oates, ‘Evolution of Fiscal Federalism’ (2008), at 315-316.} Second, central governments are subject to political constraints that prevent them from tailoring the composition of public outputs, while local governments, financed by local resources, more closely represent local needs and resources.\footnote{See infra, Chapter 3, Section 3.2.4, p 176.} The result is that central governments are pressured to provide a more uniform, ‘one size fits none’ level of public output.\footnote{Alexis De Tocqueville, \textit{Democracy in America} (vol I, Vintage Books, Random House 1945, first published in 1838).} This problem was shown to be at the root of the failure of the SGP in Section 3.3 of this thesis: Even where credit imbalances are detected by local governments, the ECB cannot customise the single interest rate to defuse macroeconomic imbalances in a specific local economy.\footnote{A plentitude of theoretical and empirical studies show that local governments in a federation often ‘do not fully internalise the cost of public expenditure and thus have an incentive to undertax and overspend’ where there is the necessary to respond to local information.} As de Tocqueville once posited it:

‘In great centralized nations the legislator is obliged to give a character of uniformity to the laws, which does not always suit the diversity of customs and of districts; as he takes no cognizance of special cases, he can only proceed upon general principles… since legislation cannot adapt itself to the exigencies and the customs of the population, which is a great cause of trouble and misery.’\footnote{See Ch 3, Section 3.2, in particular Section 3.2.4 at pp 176-183.}

Second Generation Fiscal Federalism theory (SGFF) is concerned with pathologies of fiscal federalism and the institutional precepts of fiscal discipline. It examines the distortive incentives which improperly-designed institutions can wreak on the viability of the public sector and even the economy as a whole.\footnote{‘Evolution of Fiscal Federalism’ (2008). Cf. Cremer, Estache and Seabright (1996) (noting that there is no reason why, in principle, a central authority could not overcome this asymmetry by gathering and responding to local information, though it is less valuable to a central government).} At the centre of SGFF theory is the concept of soft budget constraints. The
theory of soft budget constraints originated in the work of Kornai and the literature on government support in socialist economies, and describes the situation in which an institution does not face a ‘fixed envelope’ of resources. The essential tenet of that literature is that a government has difficulty withdrawing support from an enterprise once it has provided initial capital, and will be unable to credibly commit not to supporting a loss-making enterprise in the event of failure. Where this is so, the finances of the enterprise are subject to an implicit bail-out guarantee, and it will have perverse incentives to under-perform, insulated from the costs of its own misbehaviour.

The theory of soft budget constraints has since been expanded and applied to fiscal federalism. Where a sub-federal government can expect a bailout from central authorities, they do not face a ‘fixed envelope’ of resources and do not bear the full marginal cost of an increase in debt. Market discipline breaks down: Creditworthiness does not reflect the cost of default risk; interest premiums do not rise in proportion to own liabilities and revenues; and the sub-federal governmental unit does not bear the full marginal costs of an increase in debt. As was shown in Chapter 3, where this occurs, markets will not price default risk until the scale of such imbalances rivals the capacity to bail them out. There are a number of mechanisms by which soft budget constraints may arise in a federal system, but each has one essential thing in common: One jurisdiction internalises the entirety of the benefit of a marginal increase in expenditure, but the costs are shared with all. Shaltegger and Feld summarise:

‘These incentives particularly hold in federal systems with important tax sharing arrangements, equalisation, but low tax autonomy of the sub-national jurisdictions, or if excessively indebted regions can expect a bailout. Whenever sub-central governments perceive that the federal government provides them with funds to cope with their financial or economic stress, any possibility of sharing or shifting costs to other levels of government: Eyraud and Gomez Sirera (2014). For surveys: Qian and Weingast (1997); Rodden, Decentralization (2003); Oates, 'Towards a Second-Generation' (2005); Oates, 'Evolution of Fiscal Federalism' (2008); Weingast, 'Second generation fiscal federalism' (2009); IMF, Macro Policy Lessons (2009).


See, in particular: Section 3.3.2, pp 186ff.


Singh and Plekhanov (2005), 3 explain: ‘If a public project benefits predominantly a particular jurisdiction but receives financing through a common pool of taxes from the whole country, the jurisdiction pays only a small fraction of the costs of the project while enjoying a large share of its benefits.’ See also: Alberto Alesina, Roberto Perotti, 'Fiscal Expansions and Fiscal Adjustments in OECD Countries' (1995) 10 Econ Policy 207; Xavier Debrun and others, 'Tied to the mast? National fiscal rules in the European Union' (2008) 54 Econ Policy 299.
Federations evince a broad range of strategies for dealing with these problems. Institutional arrangements for fiscal discipline range from direct controls on spending, borrowing and taxation (as in a unitary state), to pure market discipline.  

**Figure 37 Institutional Constraints on Sub-Federal Budgetary Policy**

In support of the ‘Pringle Hypothesis’, there is a ponderous empirical literature which finds that fiscal rules can improve fiscal outcomes, depending on their design and institutional setting. Depending on their strictness and character, fiscal rules have been shown to reduce the overall level of debt issued, lower expenditures, reduce deficits, and lower or raise interest

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1950 Feld and Schaltegger (2009), 116.
1951 This chapter relies on the taxonomy first proposed Ter-Minassian and Craig and often by the IMF to assess borrowing constraints. Ter-Minassian and Craig (1997); Eyraud and Gomez Sirera (2014); Joumard and Kongsrud (2003). This ranking system has also been used by the IMF: IMF, *Macro Policy Lessons* (2009), 40; Singh and Plekhanov (2005), 6. For other versions of the federalism ‘spectrum’ see: Livingston (1956); Riker (1964).
1952 Adapted from: Eyraud and Gomez Sirera (2014), 9.
1956 Ayuso-i-Casals and others (2009).
premiums.\textsuperscript{1957} For example, Poterba finds that a $100 deficit overrun will lead to a $44 expenditure cut in US states with strong anti-deficit rules, but a $17 cut in states with weak anti-deficit rules.\textsuperscript{1958} In the EU, Debrun et al. find that the impact of fiscal rules is 'statistically significant, robust, and quantitatively important.'\textsuperscript{1959} Feld, and Tapp, reach similar conclusions for Switzerland and Canada, respectively: Stricter debt brakes are correlated with better fiscal outcomes.\textsuperscript{1960}

However, it must be emphasised that the same literature which finds that fiscal rules 'work' also stresses they are not a \textit{per se} credible instrument against excessive debt.\textsuperscript{1961} This result might be more intuitive than it might seem.\textsuperscript{1962} Not only the Union itself, but Austria, Belgium, Czech Republic, Denmark, Estonia, Finland, France, Germany, Hungary, Italy, Latvia, Lithuania, Luxembourg, the Netherlands, Poland, Spain, Sweden and the UK all had legal fiscal rules in place prior to the arrival of the crisis.\textsuperscript{1963} Yet, at the time of writing, the SGP has been violated over 120 times by all but one country (Luxembourg).\textsuperscript{1964} Clearly, simply having a debt brake is not \textit{per se} sufficient to ensure fiscal discipline and price stability.


\textsuperscript{1959} Debrun and others (2008). Similarly, Anna Iara, Guntram B Wolff, 'Rules and risks in the euro area' (2014) 34 Europe J Polit Economy 222 find that strong fiscal rules could decrease risk premiums for EU countries by up to 100bps.

\textsuperscript{1960} Feld, Kalb and Osterloh (2013). For Canada: Tapp (2013), 46 finds that BBRs and debt limits are effective, but expenditure and revenue limits are not: 'This result, which is statistically significant and economically important, is found for several fiscal outcome.'


\textsuperscript{1962} Groetke and Mause (2012), 280: 'If each jurisdiction had a debt brake then no jurisdiction in the world would find itself in danger of going bankrupt, and no one would have to bail out a jurisdiction... a brief look into Eurostat's Government Finance Statistics Database reveals that national budget rules at least have not prevented 24 of the current EU-27 countries from accumulating more public debt.'


\textsuperscript{1964} Only in Denmark Sweden and Bulgaria did the general government debt not increase. EEAG, (2011), 94.
Nor will fiscal rules necessarily improve outcomes at all.\textsuperscript{1965} In a sample of 30 countries, von Hagen and Eichengreen find that the introduction of a fiscal rule is actually associated with \textit{increased} subnational indebtedness.\textsuperscript{1966} Another 31-country panel study found no consistent effects on subnational deficits.\textsuperscript{1967} Reuter’s study of 11 EU member states from 1994-2012 yields similar results,\textsuperscript{1968} and Imbeau finds much higher variations in debt in states with fiscal rules than states with none.\textsuperscript{1969} Other meta-analyses arrive at similar conclusions: Fiscal rules do not determine empirical outcomes, while other factors, such as bailout expectations and fiscal transfers, do.\textsuperscript{1970}

Fiscal rules are not even an unalloyed good. The OECD warns that ‘inappropriate fiscal rules can be destabilising’ to an otherwise well-functioning ‘ideal type’ federation.\textsuperscript{1971} This is because, as the Lamfalussy paper and the British delegation warned at Maastricht, they can introduce larger, more injurious pathologies of soft budget constraints.\textsuperscript{1972} As the OECD finds: ‘where the government controls access to borrowing, the implicit guarantee that requiring permission to borrow creates can weaken the effectiveness of financial market discipline.’\textsuperscript{1973} As the analysis below shall bear out, swapping market discipline for centralisation is an inauspicious choice for a federal monetary union.

The literature consistently converges on five institutional preconditions for legal governance to ‘work’ in a federal system: [7.1.1] Market discipline; [7.1.2] hard budget constraints under a ‘no bailout’ rule; [7.1.3] fiscal symmetry; [7.1.4] expenditure and revenue autonomy; and [7.1.5] credibly designed fiscal rules.\textsuperscript{1974}

\textbf{7.1.1 Market Discipline}

The first condition is market discipline. The nub of the question at issue in this chapter is whether legal debt brakes can \textit{replace} market discipline in hardening the inter-temporal budget constraint.

\textsuperscript{1968} Reuter (2015), finding that fiscal rules were complied with in only half of the years for member states which had them.
\textsuperscript{1969} Imbeau (2004), 19 (finding that dysfunctional fiscal transfer incentives outweigh the disciplining effect of debt brakes).
\textsuperscript{1970} In a panel of 33 countries, Rodden, 'The Dilemma' (2002) finds that fiscal rules can mitigate some causes for deficits (partisan politics and country-cyclical spending) but not others (bailout expectations and transfer-dependency). Singh and Plekhanov (2005)’s 44-country panel reaches the same conclusion: empirical outcomes are determined by fiscal transfers and bailout precedents – fiscal rules or not.
\textsuperscript{1971} OECD, \textit{Economic Surveys: Canada 2010} (OECD, 2010), 93.
\textsuperscript{1973} \textit{Economic Surveys: Canada 2010} (2010), 93.
\textsuperscript{1974} See, e.g. Groeteke and Mause (2012), 281; Ter-Minassian (2007)
Yet the efficacy of fiscal rules *vis-à-vis* market discipline is often difficult to extricate. Not only are both used for the same task (to enforce the inter-temporal budget constraint) but, because their preconditions are the same, they often coincide. It is an unfortunate lesson of the literature that the very conditions required for effective fiscal rules are the same conditions which make them unnecessary. Complicating matters, they can either be coordinate or codependent: coordinate, because fiscal rules can heighten market discipline; and codependent, because fiscal rules do the opposite if introduced to compensate for a weak ‘no bailout’ commitment. This makes it unclear whether legal rules ‘work’ because they are supported by market discipline, or whether they are credible on their own strength.

What is certain is that market discipline, when established, is the ultimate enforcer of hard budget constraints. Under conditions of market discipline, a government which borrows against a fixed envelope of resources will face an increased marginal cost on each spending decision down the path to insolvency until, eventually, it becomes ‘cheaper to make expenditure cuts and/or raise money through taxes at home than to continue to borrow, and [borrowers] change their behaviour.’ Markets are also particularly suited to this task: First because they are democratic (unlike EU conditionality, markets do not impose specific policies on electorates); and second because they are credible – loss-bearing investors tend to be unsentimental about political justifications used to poke holes in EU rules, such as counter-terrorism, or earthquake relief.

Yet as noted throughout this thesis, market discipline has been ‘set out of work’ in the new European model. Assuming that the EU’s fiscal rules function as they are intended, their efficacy is dependent on fines (under the SGP), withholding transfers (under the ESM and OMT) or by judicial

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1975 For example, both market discipline and fiscal rules are empirically effective where there are no transfer dependencies, no bailout expectations, and a high degree of expenditure and revenue autonomy: Ter-Minassian (2007). Conversely, neither mechanism appears effective without those conditions. Bailout expectations, in particular, are fatal to both: Eyraud and Gomez Sirera (2014), 90.


1978 Tapp (2013), 46: ‘it remains unclear whether fiscal rules have a causal impact that improves the fiscal policies that governments ultimately implement, and if they do, precisely which characteristics of these rules matter.’ Imbeau (2004), 17: The stringency-conservatism relationship may well be spurious… one important question that the empirical literature does not answer is whether constitutional rules are more efficient in curbing deficit biases than market controls.’

1979 In order to remain within its inter-temporal budget constraint, a government must ensure that the present value of all its revenues is at least as large as its existing debt, plus expenditures. Lane (1993), 55.


1982 See: Sections 3.1.2, 3.1.5, 6.4.3.1, and 7.2.5.1. Cf: Groeteke and Mause (2012), 291.
enforcement (under the TSCG). In short, they are dependent on legal sanctions. This is the *modus operandi* of European governance and the normal role of legal enforcement: to alter behaviour by setting legal rules and threatening coercive enforcement by a central authority.1983

The question is whether this can ever be the equal of market discipline. In that regard, a growing literature parsing the simultaneity bias of fiscal rules versus market discipline demonstrates that, far from an equivalent substitute, market discipline is a vital antecedent to effective fiscal rules in a federation. In short, as a matter of theory and evidence, fiscal rules are sometimes an effective political constraint, and sometimes an effective focal-point for market discipline, but they are never an effective legal constraint.1984

First, the causal mechanism of law - legal rules and threatening coercive enforcement by a central authority - makes little sense in the context of fiscal rules. The very same empirical literature which shows that fiscal rules ‘work’ also shows that ‘there is essentially no evidence that these laws are directly enforced.’1985 In the 160-year history of fiscal rules across 49 US states, only once has a judicial sanction ever been used (and not until 2004).1986 In the EU, EDP fines have never been applied.1987 The IMF remarks the same phenomenon globally: Even where there is ‘a deliberate intent to breech the numerical limits’, sanctions are ‘generally difficult to implement’, ‘often lead to political instability’ and - more often than not – are ‘never intended to be used.’1988 Clearly, the effect of fiscal rules does not lie in their application, because they ‘are rarely, if ever, enforced.’1989

The intuitive reply is that they must work by deterrence - the harsher the judicial penalty, the more governments work to avoid it. But this, too, lacks explanatory force.1990 If deterrence were causal, the weight of the legal sanction should increase the effectiveness of fiscal rules, since the fear of triggering the sanction should make governments more eager to avoid it. Yet this is not so. The empirical literature repeatedly shows governments are more likely to avoid a clear fiscal rule where there are no consequences whatsoever, than they are to avoid an unclear rule with severe

1984 As Kelemen and Teo (2012), 20-21 conclude: the EU’s ‘approach to ensuring member state fiscal discipline will not work ... in part because their design is based on a misunderstanding of the role law and courts play in maintaining fiscal discipline.’ See also: Rodden, 'Fiscal Discipline in Federations' (2006); Goodspeed (2002).
1987 See: EEAG, (2011), 79, in 68 cases, sanctions should have been imposed but were not; Eyraud and Wu (2015), 12; and Commission, 'Enhancing economic policy coordination' COM(2010) 367 final, 8.
1988 IMF, Fiscal Rules (2009), 33: A full quarter of all fiscal rules globally were scrapped or simply suspended by governments in the first year of the 2008 financial crisis
consequences (if severity were what mattered, the opposite should be true). 1991 The same is true for legal basis: Clear (unenforceable) statutory rules are more effective than severe (but unclear) constitutional rules, even though statutory rules may not be enforced at all. 1992 Clear rules work better – and provide a better discount on debt – than severe fiscal rules, even they are not backed by the threat of legal enforcement.

In any event, the political science literature tells us that governments are hardly afraid of being dragged before the courts: ‘political office-holders are neither strongly nor properly influenced by financial constitutional provisions.’ 1993 Even if they were, they hardly need to fear the wrath of legal sanctions once there. Even budgetary-conscious, constitutionally-armed courts will apply a ‘light touch’ review to budgets ‘as matters of public policy best left to legislatures.’ 1994 The notion that courts will enforce fiscal rules ‘is clearly denied by the US experience’ where courts have proven ‘remarkably shy’ in wielding them. 1995 Indeed, they have proven just as likely to actively undermine them. 1996 Van Malleghem concludes:

‘In light of the US experience, it appears doubtful that national courts will be efficient enforcers of national [fiscal rules]. As in the United States, courts might progressively relax the requirements associated with these rules; and as in the United States, they might restrict the scope of these rules, giving ample margin to circumvent them.’ 1997

Delladonne finds the same phenomenon under the TSCG in the Member States. 1998 The Corte costituzionale, for instance, considers Italy’s balanced budget rule to be a political constraint, not a

1991 Erik Jones, R Daniel Kelemen, ’The Euro Goes to Court’ (2014) 56 Survival 15, 363-365 find that ‘if a rule is unclear, increasing strictness has the perverse effect of lowering the probability of getting the best credit rating.’ The strictest category of debt brake has a 75% probability of obtaining the highest rating for effectiveness if clarity is high, and a 20% probability if clarity is low. See also: Alt and Lowry (2001) (noting that governments with a deficit carry-over rule are punished more severely for consecutive deficits than governments with no rules at all); Poterba and Rueben (1999) 181; Mark Hallerberg, Guntram Wolff, ‘Fiscal institutions, fiscal policy and sovereign risk premia’ (2006) Deutsche Bundesbank Discussion Paper Series 1: Economic Studies No 35; Debrun and others (2008); Poterba and Rueben (2001); Reuter (2015).


1998 Delladonne (2014), 193 finds that the Italian, German, French and Spanish constitutional amendments have not increased the justiciability of national budgets. See also Rudolf Streinz, ’The Limits of Legal Regulation: Will the Treaty
legal one,¹⁹⁹ and the Portuguese courts have actively struck down budgets enacted to comply with the EU’s fiscal rules where they tread on competing constitutional values.²⁰⁰

Finally, even if the costs of fiscal rules were levied, such costs typically suffer from a serious incentive problem. As explained below, if market discipline has been put out of work, markets will effectively subsidise the cost of legal sanctions – the discount on debt for a bailout expectation is usually worth more than any regulatory fine.²⁰⁰¹ Electorates, too, will often reward governments for budgets which violate fiscal rules, as long as doing so is cost-free.²⁰⁰²

In sum, legal fiscal rules are simply too indirect, too unlikely to bite, and too ineffective to explain their own relationship with fiscal outcomes. There is no direct application of force between fiscal rules and outcomes; governments are not deterred by fiscal rules; and the cost-levying function of sanctions can never outweigh the cost/benefit incentives of markets and voter preferences.²⁰⁰³ And yet, as the IMF points out, fiscal rules will not be effective ‘unless the cost of breaking the rule is higher than the benefit of doing so.’²⁰⁰⁴ So what is it, then, that makes the cost of breaking a rule higher than the gains, if there is virtually no risk that sanctions will occur?

The only answer is market discipline. While there is no causal relationship between fiscal rules and empirical outcomes, there is a direct empirical relationship between fiscal rules and bond spreads, on

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¹⁹⁹ Under Article 81(3) Italian Constitution (ex Article 81(4)) ‘[i]t is clearly possible [for government] to make debts in order to provide the means for future spending.’ Corte costituzionale (Constitutional Court of Italy), Decision no. 1/1966. See: Delledonne (2014), 180.

²⁰⁰⁰ See: Amendments to the Labour Code (Portugal) (Case 602/2013) of 24 October 2013 (Tribunal Constitucional); LOE2011 (Portugal); LOE2012 (Portugal); Ruling on the 2013 State Budget Law LOE2013 (Portugal) (Case 187/2013) of 5 April 2013 (Tribunal Constitucional); Ruling on the 2014 State Budget Law LOE2014 (Portugal) (Case 474/2013) of 20 August 2013 (Tribunal Constitucional).

²⁰⁰¹ See below, Section 7.1.2. A marginal contract for debt will subsidise the cost incurred by breaching the fiscal rule if fiscal rules are introduced because of other, larger, dysfunctional incentives already in place, such as bailout expectations.


one hand, and bond spreads with government behaviour, on the other. Market discipline is ‘felt before and would be far more painful than any penalty that might eventually be meted out by a court,’ and markets reward strong fiscal rules and penalise governments which break them – even if the fiscal rule is never brought to bear. The case is that markets enforce fiscal rules, not courts.

As an empirical matter, the efficacy of a fiscal rule is not determined by strictness stricto sensu. Rather, the literature shows that to the extent fiscal rules ‘work,’ ‘they do so by acting as a focal point or coordination device that facilitates decentralized punishment of sovereigns by bond markets.’ Where fiscal rules are clear and precise, they hold aloft an unambiguous ‘red line’ recognised by all market actors and political stakeholders. This provides investors with a shared focal point and helps eliminate strategic uncertainty about whether other market actors will also lower bids on debt. Alt and Lowry, for example, find that states with low gross debt ignore deficit rules until they are punished by markets for running consecutive deficits. Similarly, Reuter’s study of 23 fiscal rules in 11 EU member states from 1994-2012 finds that governments appear take no action to avoid breaching a fiscal rule, but work to return to a debt ceiling once market sanctions begin to take effect. This is significant: Fiscal rules are triggered by a single deficit, but apply the same sanction repeatedly in a linear fashion to subsequent breaches. Markets, by contrast, do not usually consider a single deficit to entail default risk, but will penalise the same deficit exponentially the more it is repeated. This gives researchers a chance to break the simultaneity bias: Governments are complying with bond markets, not courts.

This causal mechanism ‘provides a more plausible explanation of the causal mechanism through which balanced budget rules work’ than fiscal rules themselves. The US General Accounting

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2005 Iara and Wolff (2014), 3: ‘rules become the more credible to market participants the stronger their binding character its, and the more effectively they can be enforced.’ See also: Hallerberg and Wolff (2006); Debrun and others (2008); Poterba and Rueben (1999).
2006 Poterba and Rueben (2001); Feld, Kalb and Osterloh (2013).
2007 Kelemen and Teo (2014), 358.
2008 States with BBRs pay about 7.3 bps less than states with no laws, for example, but are then punished disproportionality for running consecutive deficits: Alt and Lowry (2001), 67. See also: Poterba and Rueben (1999).
2009 Kelemen and Teo (2012), 5. Rating agencies function in the same way, but law is particularly suited to this task: governments do not commit to respecting ratings agencies in the same way, for example, and compliance with law is monitored by the public, offering a surer signal that something is wrong. See: Balassone, Franco and Giordano (2004) (on ratings agencies); Alesina (2010), 15 (on credit-ratings and fiscal rules); and Blume and Voigt (2013), 239.
2010 The payoff in unilaterally hiking rates is low, because the first investor to offer less favourable terms will be immediately out-bid if his or her fellows do not follow. Fiscal rules overcome this. See: Kelemen and Teo (2014), 356; Kelemen and Teo (2012), 6; Gillian Hadfield, Barry Weingast, 'Law without the State: Legal Attributes and the Coordination of Decentralized Collective punishment' (2013) 1 JLC 3; Richard McAdams, 'A Focal Point Theory of Expressive Law' (2000) 86 Va Law Rev 1649; Richard Cantor, Frank Packer, 'Determinants and Impacts of Sovereign Credit Rankings' (1996) 2 Economic Policy Review 37.
2013 Sutherland, Price and Joumard (2005), 36; Bayoumi, Goldstein and Woglom (1995); Alberto Alesina and others (1992); Ardagna, Caselli and Lane (2004); Balassone, Franco and Giordano (2004), 410.
2014 Kelemen and Teo (2012), 6, 18. See also: Hadfield and Weingast (2013); McAdams (2000); Reuter (2015), 77; Alt and Lowry (2001); Kelemen and Teo (2014); Poterba and Rueben (1999); Hallerberg and Wolff (2006); Debrun and others (2008); Poterba and Rueben (2001); Reuter (2015).
Office, for example, finds that market discipline is the most important causal explanation for compliance with fiscal laws in American states.\textsuperscript{2015} Other studies reach similar conclusions: Expenditure constraints and debt rules can be effective, but they only work indirectly, via improved credit ratings.\textsuperscript{2016} Kelemen and Teo conclude: ‘the actual experiences of state governments that come into conflict with [fiscal rules] is more consistent with our “law as focal point” causal argument than with the “law as threat of judicial sanction” argument.’\textsuperscript{2017} Briffault agrees: ‘The real discipline for the state comes from capital markets.’\textsuperscript{2018}

### 7.1.2 Hard Budget Constraints and a Credible ‘No Bailout’ Rule

The essential cause of the soft budget constraint is the inability of the central government to credibly commit to refuse a bailout.\textsuperscript{2019} This is typically described in a sequential game theoretic known as the ‘bailout game.’ In the bailout game, the central government commits itself to a ‘no bailout’ policy to ensure that it is not exposed to sub-federal liabilities, and markets and sub-federal treasuries then assess whether the ‘no bailout’ commitment is credible.\textsuperscript{2020} Markets evaluate both economic incentives and institutional signals when pricing risk, and the credibility of a ‘no bailout’ policy will be assessed against financial inter-dependencies (e.g. banking exposures or federal involvement in state programmes) and institutional structures (such as fiscal rules or transfer programs).\textsuperscript{2021} Such structures signal that the centre is susceptible to the economic fortunes of the sub-unit. Where markets perceive that the liabilities of the debtor will be financed by a guarantor, the creditworthiness of the debtor is assessed by the capacity of the guarantor to bail it out, rather than its own finances, and the sub-federal governmental unit does not bear the full marginal costs of an


\textsuperscript{2016} Craig Johnson, Kenneth Kriz, 'Fiscal institutions, credit ratings and borrowing costs' (2005) 25 Public Budg Finance 84; Alesina (2010), 15.

\textsuperscript{2017} Kelemen and Teo (2012), 18.

\textsuperscript{2018} Briffault (1996), 61.

\textsuperscript{2019} This is the point and purpose of the federal design in Articles 123-125 TFEU: See, \textit{infra}, Chapter 2, in particular Sections 2.2.4 and 2.3.1, pp 124-136. The ‘centre’ or ‘central authority’ may be the central bank, the central government, a confederacy of governments, or even an international institution such as the IMF. See: Wildasin (1997); Dewatripont and Maskin (1995); Goodspeed (2002); Rodden (2006); Rodden, 'Fiscal Discipline in Federations' (2006); Rodden, 'Can Market Discipline Survive?' (2014).

\textsuperscript{2020} Rodden (2006), 50-52; Wildasin (1997); Qian and Roland (1998); Goodspeed (2002).

\textsuperscript{2021} There are a number of signals that a ‘no bailout’ commitment is not credible \textit{ex-ante}. The ‘most crucial’ is a high degree of exposure to financial spillovers which indicate that the central government will be exposed to the default of the debtor \textit{ex-post}. Rodden, 'Fiscal Discipline in Federations' (2006), 138; Rodden, \textit{Decentralization} (2003), 16; Wildasin (1997); Goodspeed (2002). This can be seen in Section 3.1.5, where cross-border financial exposures and non-credible commitments from integrationist institutions undermined the ‘no bailout’ rule in Article 125 TFEU. The second is an institutional disposition towards bailouts from past failures to apply the rules. See, e.g.: Chapter 3, Sections 3.1.2, pp 155 ff, and Section 3.1.5, pp 162 ff. See further: Bovenberg, Kremers, Maason (1991) (pointing to financial interdependence); Ben Lockwood, 'Inter-Regional Insurance' (1999) 72 J Public Econ 1 (pointing to centralised shock-absorbers); Singh and Plekhanov (2005), 4 (pointing to fiscal transfer systems); Kornai, Maskin and Roland (2003), 1098-1100; Ludger Schuknecht, Jürgen von Hagen, Guido Wolsiwj, 'Government Risk Premiums in the Bond Market: EMU and Canada' (2008) ECB Working Papers No 879 (Canadian Provinces and German Länder receiving higher fiscal transfers have higher bailout expectations); Friedrich Heinemann, Steffen Osterloh, Alexander Kalb, 'Sovereign risk premia: The link between fiscal rules and stability culture' (2014) 41 J Int Money Financ 110, 124; Oates, 'Fiscal Decentralization' (2006).
increase in debt. The sub-federal government is not only able to contract for more debt than the length of its own revenues, but it has an incentive to do so, since a portion of the costs of default are ‘shifted’ to the centre. This heightens the scale of eventual calamity: While bailouts lower interest-rates, they do not dispel the underlying risk - they merely share it out. Default premiums will not reflect individual default risk until the scale of the default equals the size of the bailout capacity, plus a marginal unit of one. Oates explains:

‘it is important to understand that in such a framework [where bailouts exist], perverse fiscal behaviour is essentially built into the system. This is not simply a case where fiscal advisors can rely on directing public authorities to behave in responsible ways (as perhaps envisioned in [FGFF]). The system itself induces fiscally irresponsible behaviour: It is endogenous to the system. The solution to the problem thus involves a fundamental reform of political and fiscal institutions to alter the whole structure of incentives for budgetary decision-making.’

It is important to note that other Member States and independent central banks, too, may succumb to the same commitment-sapping incentives of Kornai’s initial provider of capital. The first and most important condition for fiscal discipline is therefore a credible commitment to a no-bailout rule. It must be emphasised that this condition is not just a stipulation of ‘ideal type’ or ‘market-preserving’ federalism - it is a prescription of the literature on fiscal rules itself. Eyraud and Sirera’s study of 13 federations is typical:

‘Constraints are not binding if subnational governments know that they can appeal to the centre for additional resources... A strong central government’s commitment is key to ensuring that

2022 Oates, ‘Towards a Second-Generation’ (2005), 365: ‘to provide extensive insurance comes at a cost of inefficiently low levels of preparation... such insurance programs could, in short, come to provide a rationale for fiscal bailouts and a general softening of budget constraints.’ See also: Lockwood, ‘Inter-Regional Insurance’ (1999).
2023 Stuart Landon, Constance Smith, ‘Government debt spillovers and creditworthiness in a federation’ (2000) 33 Can J Econ 634, 637: ‘if lenders expect that the individual jurisdictions of the federation will be supported... the creditworthiness of each member government will depend on the debt obligation of the entire federation.’

2026 One might recall here the time-inconsistency of Germany’s ‘no-bailout commitment’ (see Section 3.1.5); the inability the ECB to make-good its threat to raise collateral requirements (see Sections Figure 13 and 3.1.2), and the ECB’s own bailout mechanism to restore its ‘monetary transmission mechanism’ and the ‘singleness of monetary policy’ (Section 6.1.6). A bailout can take the form of, inter-alia, privileged access to domestic financial institutions, financial assistance at lower rates or better terms than capital markets provide, guaranteeing prospective debt contracts, or bond purchases at lower rates or higher volumes than capital markets, or expansionary monetary policy. Balassone, Franco and Giordano (2004), 394. See, e.g. Groeteke and Mause (2012) (arguing that the ECB has stepped into the role with its bond-market interventions); Faint (2006) (an expansionary fiscal policy in the EU has a higher effect on the spreads of the currency union as a whole, than it does on the specific Member State).
2027 Whatever other factors are in place in a fiscal union, extensive evidence points to the existence of bailout expectations as the leading cause of soft budget constraints and the breakdown of fiscal rules. Bordo, Jonung and Markiewicz (2013), 482, a comparative analysis of five federations, (US, Canada, Germany, Argentina and Brazil) concludes: the ‘first and probably the most important condition’ for fiscal stability is a ‘credible commitment to a no-bailout rule.’ See also: Wildasin (1997); Dewatripont and Maskin (1995); Goodspeed (2002); Blankart and Klaiber (2006); Rodden, ‘Fiscal Discipline in Federations’ (2006), 138.
institutional arrangements such as fiscal rules are enforced [and] also necessary to preserve the effectiveness of market mechanisms...

So why is it, exactly, that fiscal rules cannot work alongside bailouts? There are two reasons. First, a bailout expectation does more than insulate governments from market discipline – it actively undermines the cost-levying function of fiscal rules. Unless non-compliance with a fiscal rule is costly enough to outweigh the benefits of a marginal increase in debt, it is ‘rather unlikely that such jurisdictions would voluntarily reduce borrowing/expenditures and increase taxes/fees.’ If bailouts are afoot, this is rarely the case. This is so because, in the presence of a bailout, neither the lender nor borrower bears the full cost of default, but both internalise the full benefits of forming a debt contract. The incentive to abide by fiscal rules is therefore diminished to the extent of those benefits. In short, the discount on interest rates from a bailout expectation will subsidise the cost incurred by breaking the rule (and may reduce that cost to zero). Numerous studies confirm that countries with soft budget constraints have higher debts, higher expenditures, require more fiscal transfers, and spend their funds less efficiently – regardless of whether, and what, fiscal rules are in place.

Second, the failure of a ‘no bailout’ commitment signals that fiscal rules themselves are non-credible. It must be recalled that the originating tenet of the soft budget constraint literature is that a government has difficulty withdrawing support from an enterprise once it has provided initial capital, and cannot credibly commit to the failure of its ward. A bailout precedent will signal that the centre is exposed to the fortunes of the recipient and so is equally unable to commit to enforcing a no-bailout policy or sanctions. In countries with bailout precedents, sub-federal governments are statistically far more likely to receive a bailout than be sanctioned for breaching fiscal rules. The EU provides its own evidence for this: The EDP might, on paper, be expected to have activated at some point during the hundred-odd breaches since its inception. Instead, rule-breakers are far less

2028 Eyraud and Gomez Sirera (2014).
2029 Bailout expectations ‘sever the link’ between the expected solvency of the state and the interest rate: Hallerberg (2010), 131. See also: Seitz (2000) ‘market forces can only work efficiently if subnational governments have no perceived chance of a bailout by the central government (or the central bank).’
2030 Groeteke and Mause (2012), 291.
2031 This is particularly so if fiscal rules are introduced because of other, larger, dysfunctional incentives already in place, such as bailout expectations: Landon and Smith (2000), 637; Blume and Voigt (2013), 236. Eyraud and Sirera (2014).
2032 ‘Even of subnational governments can take simple but politically costly steps to avoid an impending fiscal crisis, it may be more rewarding to position themselves for bail-outs.’ Rodden, 'Fiscal Discipline in Federations' (2006), 144.
2033 Alexander Fink and Thomas Stratmann, 'Institutionalized Bailouts and Fiscal Policy: Consequences of Soft Budget Constraints' (2011) 64 KYKLOS 366; Dietmar Braun and Philipp Trein, 'Federal dynamics in times of economic and financial crisis' (2014) 53 EJPR 80, 808 (finding that while countries plagued by transfer-dependency are more ‘prone to cost-shifting, rent-seeking or shirking, and over-borrowing as a strategy of cost-shifting’ these still appear less often in countries with no bailout histories, such as Austria, Belgium and South Africa).
2035 ‘Governments that cannot commit to eschew bail-outs might also find it difficult to enforce borrowing restrictions or penalties for excessive deficits, especially during bad times’: Rodden, 'Fiscal Discipline in Federations' (2006), 159. See also: Groeteke and Mause (2012), 294, ‘If a jurisdiction can expect a bailout, then this weakens the credibility of a debt brake since this may weaken politician’s incentives to abide by this fiscal role.’
likely to be fined (which count stands at €0.00 fines levied) than they are to receive a bailout (which count stands at €500.07bn dispersed over eight separate programmes for five Member States).

7.1.3 Vertical Fiscal Symmetry

The third condition for fiscal discipline in a federal system is fiscal symmetry. Fiscal symmetry is the condition in which the expenditure responsibilities of each level of government are matched with independent command over an equivalent revenue capacity. As expositions by Alexander Hamilton, ‘The creation of debt should always be accompanied with the means of extinguishment.’ This ‘simple dictum’ of the federalism literature ensures that the supply of public goods is tailored to local citizens’ willingness to pay, and each bears the costs of its own mismanagement. Each government ‘stands on its own bottom.’ Oates explains:

‘There is fairly general agreement that for a sound fiscal system, the various levels of government need their own sources of tax revenues … having to rely on own revenues (rather than transfers) provides incentives for a more careful balancing of the two sides of the ledger. A condition of vertical fiscal imbalance (or “transfer dependency”) is said to exist where own-revenue systems are weak and lower level governments rely heavily on transfers from above.’

Fiscal asymmetry, by contrast, occurs where expenditure is funded by a common pool of revenues. This introduces two common-pool pathologies into the federal finances: ‘Transfer dependency’ and ‘institutional asymmetry.’

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2037 This €500.07bn figure encompasses all EU bailouts from May 2010 and December 31 2016 and excludes an additional agreed €60.75 in BoP assistance to Romania, Latvia and Hungary. Greece I: €20.1bn (IMF) + €52.9bn (BGLF). Greece II: €172.6bn (€28bn from IMF + €144.6bn from EFSF) (this included the remaining amount from Greece I, which was €110bn). Greece III: €86bn (ESM+IMF) from August 2015 to August 2018, Ireland: €68.2bn (€4.8bn bilateral + €22.5bn EFSM + €18.4bn EFSF). Portugal: €79bn (€26.3bn IMF + €24.3bn EFSM + €26bn EFSF). Spain: €43bn out of €100 ESM. Cyprus I: €2.5bn bilateral using ESM as disbursement. Cyprus II: €106 (€1bn IMF + €9bn ESM).


2040 Blankart and Klaiber (2006), 49: ‘Neither can a jurisdiction shift the burden of its budgetary outlays to other jurisdictions nor can other jurisdictions shift parts of their tax burden to the former jurisdiction.’


Transfer dependency arises where governments are incentivised to rely on fiscal transfers rather than developing their own revenue base. According to the vast empirical literature surrounding what is called the ‘flypaper effect’, funding by transfers simply does not have the same effect on public finances as own revenues. The flypaper effect is an empirical phenomenon wherein the effect of a fiscal transfer is an unmatched increase in expenditure that exceeds the increase which would occur were the revenues generated locally. Put simply, fiscal transfers cause an increase net spending - own revenues do not. This effect is, as Rodden’s study of 1978-1997 panel data from 44 countries concludes, ‘one of the most enduring empirical results in public economics.’

The result is that sub-federal governments make poorer and poorer financial decisions. Fiscal transfers have been shown to eliminate incentives for budgetary consolidation in German Länder, suspend structural reforms in Greece, and to have retarded economic convergence in Italy, while federations with limited or no fiscal transfer systems (Canada, Switzerland, or the US) evince a much higher degree of economic convergence. As Oates observes: ‘there is some troubling

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2044 This can arise due to a bailout guarantee, a shared revenue system, a high ratio of fiscal transfers to expenditure, or a non-independent central bank. Rodden, 'Reviving Leviathan' (2003), 697: ‘By breaking the link between taxes and benefits, mere expenditure decentralization might turn the public sector’s resources into a common pool that competing local governments will attempt to overfish.’


2046 The effect is also pervasive in the literature examining aid transfers: Roy Bahl, Johannes Linn, Urban Public Finance in Developing Countries (Oxford University Press 1992), 428: ‘grants can make local governments less accountable for their fiscal decisions (they may now increase spending without increasing taxes).’

2047 Fiscal transfers ‘stick where they hit’: Courant, Gramlich and Rubinfeld (1979).

2048 Each 10% increase in vertical imbalance will increase the fiscal balance by 1% of GDP: Luc Eyraud and Lusine Lusinyan, 'Vertical fiscal imbalances and fiscal performance in advanced economies' (2013) 60 J Monetary Econ 571. See: Rodden, 'Reviving Leviathan' (2003), 705, 716: ‘as an empirical phenomenon, the flypaper effect is quite universal... Increased grants to subnational governments appear to supplement rather than replace existing central government expenditure programs, while virtually the entire increase is spent by the recipient government.’

2049 Funding by transfers appears to ‘alter perceptions about the level of local expenditures that can be sustained’: Rodden, 'Fiscal Discipline in Federations' (2006), 144. Feld and Baskaran (2010), 383 find that vertical transfers ‘increase both total and administrative costs’, ‘impede fiscal consolidations’, and ‘have an unfavourable effect on the levels of public debt.’ In a comprehensive survey, Weingast (2009), 283, finds that ‘subnational governments that raise a substantial portion of their own revenue tend to be more accountable to citizens, to provide market-enhancing public goods, and to be less corrupt.’ See also: McKinnon, 'Market-preserving fiscal federalism' (1997) (transfers perpetuate, rather than close, gaps between regions); and Ronald McKinnon, Thomas Nechyba, 'Competition in Federal Systems: The Role of Political and Financial Constraints' in John Ferejohn, Barry Weingast (eds), The New Federalism: Can the States be Trusted? (Hoover 1997) 3.

2050 Among German Länder in receipt of fiscal transfers, ‘there is no indication of adjustment among recipient states at all.’ There is also ‘no indication that the recipient states restrain themselves when revenue growth is unexpectedly strong’: Rodden, 'Fiscal Discipline in Federations' (2006), 155. See also: Rodden, 'The Dilemma' (2002)

2051 Papadopoulou (2014), 226: cohesion funds in Greece ‘did not create incentives to [reform], but rather masked the underlying structural problems, making necessary adjustments less pressing to political elites and invisible to the public.’

2052 Fabio Padovano, The Politics and Economics of Regional Transfers: Decentralization, Interregional Redistribution and Income Convergence (Edward Elgar 2007)

2053 Shared revenues and transfers make up 54% of Länder revenue, but an average of 14% in the US, Canada and Switzerland: Carlo Cottarelli and Martine Guerguil, Designing a European Fiscal Union: Lessons from the experience of
evidence that intergovernmental grants often do not function as the normative theory would have them do, even in the context of a system of relatively hard budget constraints.\footnote{Oates, 'Fiscal Decentralization' (2006), 25.} The second problem is institutional asymmetry. Fiscal asymmetries imply that more liabilities are funded from a common pool and, as the central government becomes increasingly entwined in sub-federal expenditures, it becomes politically accountable and politically vulnerable to the economic fortunes of its Member States.\footnote{If local electorates blame the centre for local funding failures in healthcare, for example, ‘the very political survival of central incumbents may well depend on their coming to the aid of lower-level fiscal authorities.’ Oates, 'Fiscal Decentralization' (2006). See also: Lockwood, 'Inter-Regional Insurance' (1999); Schuknecht, von Hagen and Wolswijk (2008) (German and Canadian gov’ts which receive transfers have lower interest premiums as a result of the increased bailout expectation associated with these transfers); Weingast, 'Second generation fiscal federalism' (2009), 283. See also: Joumard and Kongsrud (2003), 41; Shah (1998); IMF, Macro Policy Lessons (2009), 18.} This leads to soft budget constraints. As Foremny so puts it, ‘the higher the dependency on central government grants and transfers, the higher the expectation of a bailout.’\footnote{Foremny (2014), 88. See also: Sutherland, Price and Joumard (2005), 29, 31: ‘disparity between expenditure and income assignment makes for a soft budget constraint.’}

In most cases, fiscal rules are incapable of offsetting these incentives. In a panel of 33 countries, Rodden found that the largest predictor of deficits or surpluses was not whether or not a debt brake was in place, but reliance on fiscal transfers.\footnote{Rodden, 'The Dilemma' (2002); Padovano (2007); Rodden, Decentralization (2003); Ambrosanio and Bordignon (2007), 28-30.} Singh and Plekhanov’s 44-country panel yields the same conclusion: Large vertical imbalances are the largest predictor of deficit bias (aside from bailouts) regardless of whether, and what, fiscal rules are in place.\footnote{Singh and Plekhanov (2005). See also: Von Hagen and Eichengreen (1995), 137: fiscal rules generally emerge ‘in states characterised by a high degree of vertical fiscal imbalance.’}

The only way to avoid this trap is to design fiscal transfers so that they do not interfere with fiscal symmetry in the first place.\footnote{Oates, Fiscal Federalism (1972); Flatters, Henderson and Mieszkowski (1974); Broadway and Flatters (1981); Oates, 'Evolution of Fiscal Federalism' (2008), 325-327; Richard M Bird, François Vaillancourt, 'Fiscal Decentralization in Developing Countries: An Overview' in Richard Bird, François Vaillancourt (eds), Fiscal Decentralization in Developing Countries (Cambridge University Press 1998) 1; Oates, 'Towards a Second-Generation' (2005), 363.} The literature prescribes three conditions which must be met if transfers are not to erode a federal system, but the overarching prescription is clear: ‘local authorities need to rely on their own revenues for financing at the margin so that decisions to expand public programs are made in full light of the additional costs.’\footnote{Oates, 'Evolution of Fiscal Federalism' (2008), 326. See also: von Hagen and Eichengreen (1995), 137.} The conditions are as follows: First, transfers must be limited to two purposes, capacity equalisation (‘equalisation transfers’) or benefit-internalisation (‘efficiency transfers’), and they must always be give ex-ante - never ex-post.\footnote{Efficiency transfers are used to ‘internalise’ spillovers from spending decisions that benefit other jurisdictions. For example, where a state-level government will be hesitant to spend money on a highway that connects the residents of two neighbouring jurisdictions, FGFF would foresee matching intergovernmental grants to compensate the local jurisdiction so that it completes the investment. Equalisation transfers are typically based on equity grounds, but seek to establish minimum capacities for ‘laboratory federalism’ – establishing a level playing field for local experimentation and public-}
Second, transfers must never finance the general budget (and thus be available for financing marginal expenditure). Third, they must be clear, predictable, and customised to their purpose. Typically, this requires some form of institutional authority to guard against the predation of sub-federal spending responsibilities through what is known as the ‘golden leash’ - the use of the federal spending power to enter into state competences using conditional finance. Otherwise, ‘cheating’ at the sub-federal level may be met by ‘cheating’ through co-option by the centre, resulting in a malign cycle of increasing fiscal asymmetry.

It should be noted that EU’s bailout programmes conform to the most distortive fiscal transfer possible. Greece’s 2010 bailout programme is characteristic. First it is an ex-post bailout (softening the inter-temporal budget constraint). Second, it is to the general government budget (where it has, in fact, been used to finance marginal expenditure). Third, it is given in exchange for (3) a ‘golden leash’ roster of conditions stretching from the retirement age to direct taxation (refracting political responsibility in all those areas in which it applies). The literature warns that fiscal rules are incapable of offsetting such incentives.

7.1.4 Revenue and Expenditure Autonomy

The fourth condition for fiscal discipline in a federation is expenditure and revenue autonomy. Groeteke and Mause explain:

‘Even when a constitutional debt brake is designed in a way that makes it difficult for a jurisdiction’s government to circumvent this borrowing constraint... if this jurisdiction is unable to react on its own to a looming public deficit by means of increasing taxes and/or reducing public expenditures (i.e. insufficient taxation/expenditure autonomy), then it can be expected that this jurisdiction reneges on its debt-brake commitment and/or asks other jurisdictions or the central bank for financial rescue.’


Bird and Vaillancourt (1998); Braun and Tein (2014), 812.

Germany, for example, has become one of the most centralized and asymmetric federations in the world as a result of ‘competence takeovers’ by Bund. See: Sections: 7.2.1-7.2.4. See also: Eric P Polten, Peter Glezl, Federalism in Canada and Germany (Polten & Associates 2014).


It is telling that two leaders of bailout recipient countries have openly referred to their bailout agreements as a ‘coup’. Suzanne Lynch, ‘Europe is looking at Ireland and does not like what it sees’ Irish Times (2 March 2016).

Cf: The optimal, symmetry-preserving fiscal transfer envisioned by the literature might be an ex-ante, targeted efficiency grant to compensate a local government for a highway linking two neighbouring jurisdictions, with all conditionality tailored solely to that infrastructure project, and accompanied by a billboard stating ‘this bridge is part-financed by the European Union.’ Robert P Inman, 'Federal Assistance and Local Services in the United States: The Evolution of a New Federalist Order' in Harvey Rosen (ed), Fiscal Federalism: Quantitative Studies (University of Chicago Press 1998); Joumard and Kongsrud (2003), 36-37.

Groeteke and Mause (2012), 290. See also Rodden (2006), 10: ‘Politically powerful subnational governments with borrowing autonomy and limited tax autonomy can be a dangerous combination.’

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The case for revenue autonomy is obvious. Where a state does not ‘own’ their own tax base, or where the central government preempts sub-federal revenue sources, it will have no choice but to increase debt or rely on fiscal transfers to extinguish its liabilities.\(^\text{2069}\) As Gunlicks puts it, ‘If the federal government has control over revenues, it is going to be difficult to sustain a meaningful federal system.’\(^\text{2070}\) Once again, this condition is more determinate of outcomes than fiscal rules: Foremny’s empirical analysis of EU15 fiscal rules from 1995-2008 finds that increasing tax autonomy increases fiscal responsibility, lowers bailout expectations, and constrains spending in a decentralised federation.\(^\text{2071}\) Fiscal rules, by contrast, were not effective, and fiscal rules that constrain revenue autonomy actually reduce creditworthiness.\(^\text{2072}\)

The case for expenditure autonomy is also more intuitive than it might seem.\(^\text{2073}\) As Alesina points out, if an electorate exhorts non-compliance with a fiscal rule, ‘there is virtually no rule which can induce an unwilling government to do so.’\(^\text{2074}\) A debt brake which precludes responses to acute political imperatives will be non-credible at the outset. Examples abound. France and Italy, for example, have poked holes in EU fiscal rules using the anti-terror budget, and earthquake relief.\(^\text{2075}\) Italian President Matteo Renzi’s challenge to the application of EU fiscal rules is characteristic: ‘What will Brussels say “no” to? Money for Amatrice [a town devastated by earthquake]? Money for schools? Two billion more for healthcare?’\(^\text{2076}\) The literature shows that any legal fiscal rule will, predictably, wilt in the face of such imperatives.\(^\text{2077}\)

### 7.1.5 The Design of Effective Fiscal Rules

Once all of the above institutional preconditions are in place, poorly-designed fiscal rules can introduce their own endogenous design flaws into the system, and ‘inappropriate fiscal rules can be destabilising’ to an otherwise well-functioning ‘ideal type’ of federation.\(^\text{2078}\) Fiscal rules must therefore be designed correctly. There are a number of ways to index the credibility of a fiscal rule,
but two main methodologies dominate: The Advisory Commission on Inter-governmental Relations (ACIR) index and the Inter-American Development Bank (IADB) index of borrowing autonomy.\footnote{2079} The criteria vary slightly under these methodologies, but the main factors weighed in the balance are: (i) the type of fiscal rule (i.e balance and debt rules outperform expenditure rules, while expenditure limits outperform tax limits);\footnote{2080} (ii) monitoring and enforcement mechanisms (independent and automatic \textit{ex-post} enforcement outperforms \textit{ex-ante} political commitments);\footnote{2081} (iii) strength of legal basis (i.e. constitutional rules outperform statutory ones);\footnote{2082} and (iv) clarity and comprehensiveness. Other authors and institutions come up with similar lists for indexes in the EU, OECD Countries,\footnote{2084} the US, Canada,\footnote{2085} and internationally.\footnote{2087}

\subsection{Sub-Criteria 1: Type of Rule}

The first criteria is the type of rule. There are four main types of fiscal rule, depending on the aggregate they constrain: (1) Numerical debt rules set a numerical limit for debt or deficits; (2) balanced-budget rules (BBRs) require the budget to reach equilibrium on an annual or cyclical basis; (3) expenditure limits constrain expenditure to a given aggregate (often as a percentage of GDP, specific revenues, etc.); and (4) revenue rules set ceilings or floors on taxes.\footnote{2088} Two of these in particular may be dismissed out of hand: The literature shows that spending limits do not appear to be effective,\footnote{2089} and rules that restrict revenues are correlated with negative outcomes.\footnote{2090} The

\footnote{2079} The ACIR index depends on two scores: The strictness the balanced-budget objective (i.e., whether ex ante, ex post, whether annual or multi-annual, and whether automatic); and whether the rule is imposed by a higher level of government and has a binding legal basis (such as constitutional law) or whether the rule is self-imposed and merely legislative or non-binding. The IADB ranks the debt rules primarily based on the flexibility of the limit - i.e., whether debt is subject to a numerical constraint or authorisation is required and (2) the extent to which ownership of financial institutions may increase borrowing autonomy or support contingent liabilities. Sutherland, Price and Joumard (2005).

\footnote{2080} Debrun et al (2008); Poterba and Rueben (1999); Sutherland, Price and Joumard (2005), 6; Poterba and Rueben (2001).

\footnote{2081} Ayuso-i-Casals and others (2009); Maltritz and Wüste (2014).


\footnote{2083} Debrun and others (2008): Deficits rules must: (i) use ex-post deficit accounting, (ii) be constitutionally grounded, (iii) enforced by an independent and open review body, (iv) contain significant sanctions and (v) be difficult to amend. They offer an index of strength based on statutory basis, independent body, enforcement, and visibility. Bohn and Inman (1996) find that fiscal rules are only effective when they constrain \textit{ex-post} (not prospective) debt sums; are enforced in constitutional (not statutory) law; and enforced by an independent (not appointed) judiciary.

\footnote{2084} Sutherland, Price and Joumard (2005) offers a composite indicator of rules in 18 OECD countries, emphasising statutory basis, independent enforcement, clarity and transparency, flexibility, revenue autonomy, and comprehensiveness; Ter-Minassian (2007) identifies five design factors for effective fiscal rules: A robust legal basis (i.e., constitutional over legislative); strength; transparency; independent and credible sanctions; and public monitoring.


\footnote{2086} Tapp (2013), 46; Imbeau (2004); \textit{Economic Surveys: Canada} 2010 (2010), 93.


\footnote{2088} For a review of the main types and their effectiveness, see: Mark W Crain, James C Millar, 'Budget Process and Spending Growth' (1990) 31 WMLR 1021; Schaechter and others (2012)

\footnote{2089} See literature surveyed in Rose (2010), 823-824. Finding no significant difference between states with tax and expenditure limits and those without: Daphne Kenyon, Karen Benker, 'Fiscal Discipline: Lessons from the State
'Pringle Hypothesis' must be considered flawed where those types of rule are concerned, and the EU’s new expenditure benchmark is not likely to make a difference to the application of the SGP. BBRs and debt-limits are the most effective, and this is what is used in the European Union under the SGP, and the TSGC. However, it should be noted that this is only so if the budget rules are ex-post. Ex-ante rules, and rules which allow budgetary carry-overs, do not have the same effects. Compared to these criteria, Directive 2011/85/EU and TSGC actually prescribe quite little. Those instruments do not say whether the budget balanced should be the one submitted to the legislature or the one executed; they do not require a constitutional or a statutory law; and they do not describe whether the rule is ex-ante or ex-post. For example, Italy’s balanced-budget rule is enacted in national law by Constitutional Law 1/20142 and reinforced by Law no 243/2012. These have resulted in a (now amended) Article 81(1) and (2) of the Italian Constitution which does not, in fact, require Italy to adhere to a numerical balance, but rather to achieve a cyclical MTO - ‘a benchmark which is easily and frequently modified.’ This has already been used to ‘de-activate’ the national correction mechanism in several instances. Gros and Aldici confirm that this problem is, in fact, rendering Member State fiscal rules required under the TSGC and Directive 2011/85/EU hollow.

7.1.5.2 Sub-Criteria 2: Strength (Strictness v Flexibility)

Once the correct rule is chosen, ‘strength’ is governed by a balance of strictness and flexibility. A rule which is too strict and brittle, or too flexible and weak, will be non-credible.
A state facing a budget deficit has three choices to avoid triggering legal sanction: they can change the budget execution (raise taxes or lower spending); amend the law; or attempt to circumvent the rule. The public choice literature shows that vote-seeking governments are unlikely to choose unpopular expenditure cuts or tax raises unless the alternatives are infeasible. This long body of research has generally found that stricter rules - those that are based on ex-post numerical constraints, under constitutional law, and independently enforced - are correlated with better outcomes. Alesina and Bayoumi, for example, find that moving from no fiscal rule to a strict BBR on the ACIR index will reduce cyclical variance in fiscal balance by about 40%. Similar findings have been found in the EU, Canada, Switzerland and internationally. Notable ‘design flaws’ in that regard can include making exceptions too flexible; inadequate checks and balances or oversight; or providing the government the capacity to amend or define the operation of escape clauses.

On the other hand, a rule which is so strict that it precludes responses to acute political imperatives in a democracy will also be non-credible from the outset. No European constitution places a BBR over whatever formula defines constitutional democracy in that country. A population made to suffer enough will eventually induce elected officials to abrogate a debt brake, and so politicians will only respect the rule if the utility of doing so exceeds the utility of breaking it. Manasse, for example, models a debt ceiling under which the policymaker is presented with a trade-off between sanctions and the political benefits of economic stabilisation. They find that a penalty must be ‘unreasonably high’ to offset the reward of stabilisation. What is crucial to the idea, they caution, is that ‘the government can always choose not to abide by the “law” when it is optimal to do so.’ Simpson and Wesley also find that compliance with fiscal rules hinge on ‘a choice between keeping legislated

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2101 Groeteke and Mause (2012), 291.
2102 Crain and Millar (1990) (using cross-sectional data from 50 US states from 1979-1986, finding that constitutional balanced budget requirements are associated with 1% lower spending growth. Cf: Blume and Voigt (2013) (finding that constitutional debt rules offer only marginal improvement dependent on other, political factors, such as public awareness).
2105 Debrun and others (2008); Ayuso-i-Casals and others (2009); Maltritz and Wüste (2014); Iara and Wolff (2014).
2106 Tapp (2013); Genevieve Tellier, Louis Imbeau, 'Budget deficits and surpluses in the Canadian provinces: a pooled analysis' (European Public Choice Society Annual Conference, Berlin, April 2004).
2107 Feld, Kalb and Osterloh (2013).
2108 Alesina and others (1999); IMF, Fiscal Rules (2009)
2109 Debrun and others (2008), 302 (escape clauses help alleviate the potential inconsistency between appropriate economic policy and the objective of fiscal discipline).
2110 'Fiscal rules ‘must be written in such a way that it provides some flexibility, in order to be functional, yet not so flexible that it becomes a non-binding constraint.’ Kennedy and Robbins (2001), 44. See also: Ayuso-i-Casals and others (2009); Sutherland, Price and Joumard (2005), 26. Economic Surveys: Canada 2010 (2010), 88 (on Ontario’s debt brake).
2111 If compliance with the fiscal rule loses popular support, it will cease to be effective: Blume and Voigt (2013), 236.
2112 Manasse (2007), 466.

307
commitments to balance budgets or relenting to public pressure.\footnote{Simpson and Wesley (2012), 308. See also: Debrun and others (2008), 302 (escape clauses help alleviate the potential inconsistency between appropriate economic policy and the objective of fiscal discipline).} An unbending fiscal rule will thus prove rather brittle in a crisis. As shown in Section 3.3.4, the 1999-2005 SGP breached by Germany and France is a perfect specimen of a debt brake that is at once both too strict and too brittle.\footnote{Those countries ‘simply could not afford to play by the rules of the game.’ See: Joerges (2013). Dermot Hodson, Imelda Maher, ‘Soft law and sanctions: economic policy co-ordination and reform of the Stability and Growth Pact’ (2004) 11 J Eur Public Policy 798 (examining the tension between flexibility and weakness); David Mayes and Matti Virén, ‘Pressures on the Stability and Growth pact from asymmetry in policy’ (2004) 11 J Eur Public Policy 781; Buiter and Grafe (2003) (citing ‘insufficient flexibility [and] politically motivated manipulation of the framework and the process’).} The 2005-2011 SGP, by contrast, is a perfect specimen of a debt brake which is too flexible and weak.\footnote{A for a country with a 70% debt-to-GDP, that iteration was compatible with any result from a complete return to balance to a deterioration of 10 percentage points within a decade: EEAG, (2011), 79.} The new EU fiscal rules fiscal rules vary under this criteria, but, in general, appear to fare little better. Under the amended SGP, sanctions only bite once the target level is breached and this is not excused by the economic cycle and the efforts to return to the MTO are insufficient.\footnote{Eyraud and Gomez Sirera (2014) suggest this scaled approach probably reflects a ‘lack of credible enforcement tools.’} In 2015, the Commission released an interpretive communication outlining no less than seven accounting exceptions under its ‘margin of interpretation.’\footnote{European Commission, ‘Making the Best Use of the Flexibility within the SGP’ COM(2015) 12 final.} In particular, the interpretation of ‘an appropriate annual improvement of the cyclically-adjusted budget balance’ means the 0.5% benchmark will only ever apply to a Member State with a negative output gap of better than -1.5% of GDP.\footnote{European Commission, ‘Making the Best Use of the Flexibility within the SGP’ COM(2015) 12 final.} Then, if that is triggered, neither the TSCG nor the SGP will apply where there is ‘an unusual event outside the control of the Contracting Party’ or a ‘period of severe economic downturn.’\footnote{This exception is similarly-worded to Article 122(2) TFEU, suggesting that a ‘severe economic downturn’ has now plagued the Euro for half of its existence – a reading which the Commission has appeared to confirm in its interpretive communication.} As the Commission’s 2014 review notes, in spite of all the amendments, ‘Overall, the [SGP] was made more flexible via the possibility to adapt the pace of fiscal consolidation.’\footnote{The macroeconomic imbalance procedure fares even worse: the IMF finds that the Commission has exercised ‘excessive discretion in enforcement’ and ‘held back in applying the enforcement tools at its disposal – even though several countries have been diagnosed with excessive imbalances.’}
Nor does the TSCG help matters. The amended German,\textsuperscript{2124} Spanish,\textsuperscript{2125} and Italian\textsuperscript{2126} fiscal rules, for instance, all contain emergency exceptions determined by absolute majority.\textsuperscript{2127} This makes the exceptions even less strict than in the US or Switzerland, where exceptions are typically determined by supermajority (see below).\textsuperscript{2128} Theory and evidence suggest these are unlikely to be strictly enforced, and continuous recourse to these escape clauses is already in evidence.\textsuperscript{2129}

7.1.5.3 Sub-Criteria 3: Sanctions

As noted above, the literature shows that sanctions make remarkably little difference to the effectiveness of a fiscal rule. Nonetheless, if a legal debt brake is to ‘work’, whatever sanction it yields must actually be applied.\textsuperscript{2130} Most obviously, this requires that the rule not be under the thumb of the executive.\textsuperscript{2131} Examples of this can be seen in Canada in 2004-2008 (when three provinces with the strictest debt brakes simply amended them),\textsuperscript{2132} the constant cycle of amending and re-drafting fiscal rules in some US states,\textsuperscript{2133} and, indeed globally: The IMF finds that a full quarter of all debt brakes globally were suspended or simply scrapped by governments in the first year of the 2008 financial crisis alone.\textsuperscript{2134} One solution to this is to establish independent and

\textsuperscript{2124} Article 115(2) Basic Law: ‘In cases of natural catastrophes or unusual emergency situations beyond governmental control and substantially harmful to a state’s financial capacity, these credit limits may be exceeded on the basis of a decision by a majority of the members of the Bundestag.’ See also, Grootek and Mause (2012), 286: Germany’s new Fiscal Council is non-credible because it is composed of Government Finance Ministers.

\textsuperscript{2125} Article 135(4) Spanish Constitution, establishing an exception for ‘natural disasters, economic recession or extraordinary emergency situations that are either beyond the control of the state or significantly impair the financial situation or the economic or social sustainability of the state.’

\textsuperscript{2126} Article 81(2) Italian Constitution, referring to ‘the effects of the economic cycle, or exceptional circumstances.’ See: Boggero and Annicchino (2014). The balanced budget rule is Constitutional Law No. 1/2012 on the introduction of the balanced budget principle in the constitution, accompanied by Law No. 243/2012. Boggero and Annicchino (2014) conclude that ‘because of the many loopholes in the Italian [version], the new Treaty won’t per se change or straighten out the Italian approach responsible for the current public debt situation.’ Delledonne (2014), 194: ‘National executives generally command strong and quite cohesive majority support within the legislature.’

\textsuperscript{2127} Delledonne (2014), 194.

\textsuperscript{2128} Sections 7.2.2 and 7.2.3.

\textsuperscript{2129} Italy’s 2014 National Stability Programme, for example, deviated by the MTO adjustment path by 0.6% of GDP on the basis that ‘European and national regulations provide for flexibility that allows from deviating from the path toward the MTO.’ At the same time, the Italian government defused the threat of national law by passing a report through Parliament by absolute majority, in accordance with the exception in Article 6 of Italian Law 243/2012: Italian Republic, Italy’s Draft Budgetary Plan 2013 (Ministero Dell’Economia e Delle Finanze, 2015), 3.

\textsuperscript{2130} Blume and Voigt (2013): ‘If existing spending limits are not in the (short-term) interest of politicians, politicians may simply ignore them… Compliance with constitutional deficits rules is likely only if noncompliance is heavily sanctioned.’

\textsuperscript{2131} ECB, ‘Fiscal Councils in EU Countries’ (2014) ECB Monthly Bulletin June 1996: in order to have effect on outcomes, fiscal councils should be strictly independent from political interference; have a comprehensive mandate; be sufficiently resourced; and have a public voice, in order to effectively mobilise public opinion and discipline political incentives.

\textsuperscript{2132} See: Section 7.2.4.4. Tapp (2013) (40% of all fiscal rules in Canada have been repealed, amended or allowed to lapse).

\textsuperscript{2133} In US States debt is routinely increased through constitutional amendment: Kiewiet and Szakat (1996), 76.

\textsuperscript{2134} IMF, Fiscal Rules (2009).
automatic sanctions: Bohn and Inman, for example, find that fiscal rules enforced by elected judges are more effective than rules enforced by appointed ones.2135

Short of making sanctions fully automatic, however, sanctions are difficult to make credible even under ‘independent’ monitoring. In ‘bailout’ federations, profligate governments are still more likely to receive additional fiscal transfers than pay fines, regardless of how they are enforced.2136 Germany, Austria, Spain, and the EU itself are all more likely to see bailouts than sanctions – despite independent enforcement.2137 In the EU in particular, the Commission plays the role of independent watchdog, but its minutes are replete with examples of political capture.2138 Take, for example, the 2016 minutes recording the decision not to apply the SGP to Portugal:

‘The decision was, to a certain degree, political, in the positive sense of the word. [The Commission President] also noted that certain rules and procedures, although they had been proposed by the Commission and adopted by the Member States in the Council, could usefully be adapted in order to avoid emergency situations with regard to issues of such importance.’2139

7.1.5.4 Sub-Criteria 4: Clarity and Transparency

Strictness as clarity - not strictness as severity - is what governs the effectiveness of fiscal rules. The literature repeatedly shows that the effectiveness of a fiscal rule is determined by the clarity the law brings to a breach, not the legal weight of the axe which hangs above it.2140 Kelemen and Teo, for example, find that the strictest category of debt brake has a 75% probability of obtaining the highest rating for effectiveness if clarity is high, and a 20% probability if clarity is low. If a rule is unclear, however ‘increasing strictness has the perverse effect of lowering the probability of getting the best

2135 Bohn and Inman (1996), 378. Such rules might include an automatic requirement to increase taxes, the withdrawal of fiscal payments or investments, or the withdrawal of voting rights in central legislative houses. See also: Eyraud and Gomez Sirera (2014); Sutherland, Price and Joumard (2005), 22; Grooteke and Mause (2012), 287.
2137 Eyraud and Gomez Sirera (2014).
2138 Conditional finance under the ESM also (theoretically) entail automatic consequences in the event of non-compliance, because a state which fails to adhere to its commitments immediately loses the benefit of the next bailout instalment. However, this doesn’t work, because the ESM and OMT have simply moved into the position of Kornai’s initial provider of capital. In 2012, where Greece didn’t make its bailout terms, it simply received a bridge loan at already concessionary rates: Niki Kitsantonis, ‘Creditors Withhold 2 Billion Euro Bailout Payment From Greece’ The New York Times (9 November 2015).
2139 European Commission, Minutes of the 2155th meeting on Friday 5 February 2016 PV(2016) 2155 final (2016), 15. In European Commission, Minutes of the 2117th meeting on Wednesday February 2015 PV(2015) 2117 final (2015), 25, when deciding not to ask France to comply with the minimum adjustment required under the SGP, Commissioners were reminded that ‘the European system of economic and budgetary governance in the Union was not just a technical exercise but a political one. Its fundamental aim was not to punish Member States, but to guide and encourage them…’ Grooteke and Mause (2012), 287; there will still be no politically independent enforcer of the Stability and Growth pact.
2140 See: Section 7.1.1. Kelemen and Teo (2014), 356, 366: ‘Balanced budget rules will work better where they provide a clear focal point for investors, not where they are designed to be stringently enforced by judicial authorities. See also: Alt and Lowry (2001) (finding that the efficacy of debt brakes is not determined by strictness stricto sensu, but by the extent that strictness brings clarity to a breach); Debrun and Kumar, ‘Fiscal Institutions' (2007) (transparency and clarity are sufficient to establish credible fiscal rules); Sutherland, Price and Joumard (2005); Ambrosanio and Bordignon (2007), 11 (‘it is essential that… they are transparent, comprehensible and unambiguous’).
credit rating.\textsuperscript{2141} Other studies yield similar results.\textsuperscript{2142} The IMF notes that fiscal frameworks that are simply transparent and credible are also effective, even though they don’t involve fiscal rules at all.\textsuperscript{2143} Van Malleghem concludes:

‘Enshrining a [fiscal rule] into a document of constitutional or equivalent rank seems more of a symbolic gesture to appease markets than an effective means of preventing excessive deficits.’\textsuperscript{2144}

Fiscal rules must be designed with this reality in mind: The gavel cannot supplant the bank and the ballot box. Complex rules merely confound their true enforcers. In that regard, economists already find that the EU’s new fiscal rules fail at this essential hurdle.\textsuperscript{2145} First, the proliferation of targets under the new system has rendered it essentially unintelligible. An IMF staff paper, for example, notes eight separate budget constraints targeting six separate fiscal aggregates, each with sub-rules, cross-amendments and overlaps, resulting in ‘redundancies, and inconsistencies.’\textsuperscript{2146} The Five Presidents Report admits as much: ‘the addition of numerous ‘packs,’ ‘pacts,’ ‘procedures’ and manifold reporting requirements has blurred its rationale and effectiveness.’\textsuperscript{2147}

Second, the ‘triggers’ which set off the SGP and TSCG - the concepts of a structurally balanced, ‘cyclically-adjusted balance net of one-off and temporary measures;’ the MTO adjustment path; and ‘country-specific sustainability risks’ - are nebulous concepts for measuring budgetary risk.\textsuperscript{2148} Estimates of the structural deficit widely vary by institution (the Commission, IMF and OECD all come up with different definitions) and between supranational and national level.\textsuperscript{2149} The average

\textsuperscript{2141} Kelemen and Teo (2014), 365: ‘If a balanced budget rule is unclear, increasing the strictness of legal enforcement will not increase its effectiveness.’

\textsuperscript{2142} In a study of Canadian provinces from 1981-2007, Tapp (2013), 47 concludes that ‘the key characteristic of effective rules appears to be the specificity of the rule’s requirements, such has having clear numerical objectives.’ See also: Blume and Voigt (2013) (clear statutory rules are more effective than unclear constitutional ones); Debrun and Kumar, ‘Fiscal Institutions’ (2007) (transparency and clarity are sufficient to establish credible fiscal rules); Bohn and Inman (1996) (the legal basis of fiscal rules does not have a statistically significant effect). Cf: Debrun and others (2008), 335 (media impact had less of an impact than statutory basis, which showed the highest influence).

\textsuperscript{2143} IMF, Fiscal Rules (2009).

\textsuperscript{2144} Van Malleghem (2014), 165.

\textsuperscript{2145} Eyraud and Wu (2015), 16-17: ‘The rules of the system have become exceedingly complex. Successive legislative changes have added new constraints and procedures, creating possible inconsistencies and redundancies.’

\textsuperscript{2146} IMF, Staff Report for the 2014 Article IV Consultation (Euro Area Policies) (IMF, 2014).


\textsuperscript{2148} Art 3(3)(a) TSCG; Art 5 of Reg 1466/97. Van Malleghem (2014), 168 (‘annual structural balance’ crucially depends on the inherently uncertain exercise of economic forecasting’); Briffault (1996), 168 (these concepts are both ‘inherently unreliable and prone to significant measurement errors’); Roel Beetsma, Massimo Giuliodori, Peter Wierts, ‘Planning to cheat: EU fiscal policy in real time’ (2009) 24 Econ Policy 753, 682; Bütter and Grafe (2003). As Menéndez (2014), 137 points out: ‘It seems to me that more than an “essentially contested concept”, “structural deficit” is an indeterminate concept [it] may well turn out to be a fully discretionary constitutional term.’

error in estimating GDP growth after the year has actually ended is half a percentage point.\textsuperscript{2150} This is a huge margin of error, considering that this is precisely the floor of the TSCG. Ex-ante predictions fair even worse.\textsuperscript{2151} Empirical work by Frankel and Schreger, Beetsma et al. and others, for example, find that the ‘optimism’ bias in fiscal forecasts in European countries is 0.52\% at the 1-year horizon, 2.29\% at the 2-year horizon, and 2.4\% at the 3-year horizon.\textsuperscript{2152} EU governments consistently over-calculate growth, tax, and budget forecasts to comply with the SGP, then claim that shortfalls are cyclical, rather than structural.\textsuperscript{2153}

This same dilemma plagues the MIP/EIP which, by all accounts, appears unenforceable (see Section 7.2.5.4). In particular, the triggers for the MIP/EIP – the concepts of ‘imbalance’ and ‘excessive imbalance’ have no firm quantitative basis at all, leaving ‘great room for arbitrary judgement and, therefore, for political bargaining.’\textsuperscript{2154} Nor does the TSCG assist much. The MTO and the adjustment path are moving targets; the deficit is structural, which makes the assessment subject to ‘abstraction of the economic cycle of booms and busts’; and the objective of ‘balanced budget’ is, in reality, -1\%, -0.5\%, or the MTO, depending on the circumstance.\textsuperscript{2155} Kelemen concludes:

‘Investors would be hard pressed to find a clear fiscal red line in the opaque language of the Fiscal Compact.’\textsuperscript{2156}

7.1.6 Lessons from the Literature on Fiscal Federalism

The principal conclusion of this analysis is that centrally-imposed budgetary constraints only work if certain institutional preconditions are present, and then only if there are no endogenous design failures in the fiscal rule itself. This analysis extracts five criteria for European fiscal federalism which will be applied by comparative analysis for the duration of this chapter:

[7.1.1] First, legal fiscal are never credible in a decentralised federation in the absence of market discipline. There is no causal mechanism between fiscal rules and empirical outcomes; governments

\textsuperscript{2150} The structural balance is prone to over-estimation in the order of 0.5\% of potential GDP per year: IMF 2014 Article IV Consultation (Euro Area) (2014), 12; Buttonwood, 'The perils of planning on the basis of economic forecasts' (2015).

\textsuperscript{2151} The IMF notes that the structural balance indicator relies on the notoriously unreliable variable of output gap estimates, which are prone to disputes, misestimation, and which ‘are generally underestimated in real time’. 2014 Article IV Consultation (Euro Area Policies) (2014), 12; Eyraud and Wu (2015), 19.

\textsuperscript{2152} Jeffrey Frankel, Jesse Schreger, 'Over-optimistic official forecasts and fiscal rules in the eurozone' (2013) 149 Rev World Econ 247, 248.

\textsuperscript{2153} Frankel and Schreger (2013); Beetsma, Giuliodori and Wierts (2009). Buttonwood, 'The perils of planning on the basis of economic forecasts' (2015) concludes: ‘The whole forecasting business has an air of unreality... And the government’s entire tax and spending forecasts are based on this unreality.’

\textsuperscript{2154} See Section 8.4.2. Dabrowski, 'Fiscal and Macroeconomic Governance' (2015), 15. The notion of ‘imbalance’ and ‘excessive imbalance’ are not only defined loosely, but based notoriously subjective and imprecise measures. For example, during Ireland’s housing bubble, the national regulators, the IMF, and the Commission all came to different assessments of the scale and implications of the Irish housing sector: Manuela Moschella, 'Monitoring Macroeconomic Imbalances: Is EU Surveillance More Effective than IMF Surveillance?’ (2014) 52 JCMS 1273, 1275; Chalmers (2012), 692.

\textsuperscript{2155} Van Malleghem (2014), 162.

\textsuperscript{2156} Kelemen (2015), 396. See also: Buiter and Grafe (2003): ‘There is no coherent conceptual framework to structure and focus the assessment of the likelihood and significance of one or more numerical threshold being exceeded.’
are not deterred by fiscal rules; and even where debt brakes are effective, the cost-levying function of legal sanctions can almost never outweigh the cost/benefit incentives of markets and voter preferences.\textsuperscript{2157} There is, however, a direct causal relationship between fiscal rules and bond spreads, on one hand, and bond spreads and empirical outcomes, on the other.\textsuperscript{2158} Put simply, markets enforce fiscal rules – not courts.

[7.1.2] Second, as an empirical matter, legal fiscal rules do not work effectively under soft budget constraints.\textsuperscript{2159} This is so, first, because bailout expectations indicate that fiscal rules themselves are non-credible, and, second, because soft budget-constraints actively undermine the cost-levying function of fiscal rules.

[7.1.3] Fiscal symmetry is an indispensable condition for fiscal discipline in a federal system.\textsuperscript{2160} According to the flypaper effect, inefficient fiscal transfers distort marginal incentives, refract fiscal accountability, and ultimately lead to soft budget constraints.\textsuperscript{2161} Fiscal rules are not capable of offsetting such incentives once they are in motion.\textsuperscript{2162} In order to preserve fiscal symmetry, fiscal transfers must preserve marginal cost incentives.\textsuperscript{2163} The EU’s bailout programmes violate all of those conditions.

[7.1.4] Revenue autonomy is necessary because the means of debt-creation ‘should always be accompanied with the means of extinguishment,’ and expenditure autonomy is necessary because a population made to suffer enough will eventually induce elected officials to abrogate or abolish a debt brake.\textsuperscript{2164}

[7.1.5] Finally, even if all of the above institutional preconditions are met, failures endogenous to the design of fiscal rules may undermine otherwise stable fiscal institutions. In particular, the most important criteria is clarity: Empirical evidence shows that even the strictest category of debt brake is ineffective where it does not provide a signalling function to electorates and markets. In that regard, the EU’s fiscal rules suffer from fundamental design failures that are well established in the literature.

\textsuperscript{2157} IMF, Fiscal Rules (2009), Poterba (1995); Tapp (2013), 46; Simpson and Wesley (2012); Debrun and Kumar, 'Fiscal Rules, Fiscal Councils and all that: Commitment Devices, Signaling Tools or Smokescreens?' ; Lilco, Homes and Sameen (2009); Simpson and Wesley (2012); Debrun and others (2008).
\textsuperscript{2158} Iara and Wolff (2014), 3; Hallerberg and Wolff (2006); Debrun and others (2008); Poterba and Rueben (1999); Poterba and Rueben (2001); Feld, Kalb, Osterloh (2013); Kelemen & Teo (2014); Kelemen & Teo (2012), 5; Alesina (2010), 15.
\textsuperscript{2159} Blankart and Klaiber (2006); Rodden, 'Fiscal Discipline in Federations' (2006), 138; Goodspeed (2002)
\textsuperscript{2160} IMF, Macro Policy Lessons (2009), 14.
\textsuperscript{2162} Rodden, The Dilemma' (2002); Singh and Plekhanov (2005); von Hagen and Eichengreen (1995), 137.
\textsuperscript{2164} Hamilton (1826)
In simple, the literature suggests - with a remarkable degree of consistency - that the ‘Pringle Hypothesis’ is wrong. Legal governance cannot replace market discipline in the presence of an institutionalised bailout expectation, and, in so far this is so, increasing centralised legal governance will only undermine fiscal discipline.

7.2 Lessons from Comparative Fiscal Federalism

In order to test these legal determinants in operation, the remainder of this chapter applies these five principles to a comparative analysis of the EMU against the world’s oldest four fiscal federations: The Swiss Confederation (established 1848), the United States of America (1789), Canada (1867), and the Federal Republic of Germany (reconstituted in 1949 from the German Reich, established 1871). These four countries are the longest-running laboratories in which theories of fiscal federalism are developed and tested. Together, they combine for nearly seven centuries of empirical data across over 106 sub-federal government units.

The federations selected for this analysis have been chosen according to a ‘most similar cases’ methodology: They provide useful control factors for the main variables not central to this study, but differ in the terms of the subject of this study - the legal determinants of fiscal discipline which define European fiscal federalism.2166 This comparative analysis is a necessity exhorted by European constitutional scholars and economists alike. As Adams, et al. observe, in the absence of a laboratory, comparative analysis is necessary to ‘provide empirical data, factual outcomes of theoretical economic forces, and predict the impact of fiscal rules on the EU’s legal requirements.’2167 On all relevant variables for this study, the five federations chosen are widely recognised as the most relevant comparators for the EMU:2168 They consistently rank within the top five decentralised OECD federations in terms of sub-national spending, public employment, and revenues;2169 they are characterised by well-developed financial markets and a high degree of socioeconomic heterogeneity;2170 and all are currency unions under an independent central bank running a price-stability monetary policy. They differ, however, in terms of the object of this study: Each of the four federations occupy a different place on the institutional spectrum of fiscal restraints. The Swiss,

2165 This section employs a positive economic analysis of the law methodology for using economic theory to explain or predict certain facts. See: Faust (2008), 839- 847: ‘Positive economic analysis may be employed retrospectively that is, in order to explain why the law-be it statute or case law-developed in a specific way.’ On the application of this method to comparative analyses, see: Faust (2008), 839- 847. In the contest of financial markets, see: Black (2010).
2166 Hirschl (2005). Supporters of the EU fiscal rules often claim, for example, that the existence of fiscal rules in some of these federations implies the necessity of fiscal rules in the EMU. See: von Hagen and Eichengreen (1995), 135, rejecting this argument; and Adams, Fabbrini and Larouche (2014), 6.
2169 They differ sharply, however, in discretion over setting tax rates and bases. German Länder derive much of their income from revenue-sharing and have little right to set their own tax parameters. See, e.g., Joumard and Kongsrud (2003), 11.
2170 Begg (2009), 21; Eyraud and Gomez Sirera (2014); Broschek, 'Pathways of Federal Reform' (2014).
American and Canadian federations are decentralised federations in which subnational governments are highly autonomous, do not rely on fiscal transfers, and operate under a credible no-bailout expectation. Germany, by contrast, is a highly-centralised ‘surveillance’ federation, characterised by common-pool revenues, bailout expectations, weak market discipline and centralised legal constraints. As regards the design of their transfer systems, all four are spaced roughly equally along the federal spectrum.

The selection of these four federations also conforms to a ‘prototypical cases’ methodology, because their institutional configurations are prototypical of the two basic taxonomies of fiscal federalism considered in this thesis. The former three federations (the US, Canada, Switzerland) provide useful proxies for the decentralised Maastricht model of ‘ideal type’ or ‘market-preserving’ federalism inscribed in the Treaty since Maastricht. Germany, by contrast, provides a useful proxy for the ‘Pringle Hypothesis’ (bailouts + fiscal rules) upon which the emergent European ‘fiscal union’ is based.

7.2.1 The Federal Republic of Germany

The contemporary German Federal Republic is something of a ‘disguised unitary state,’ plagued by transfer dependency, over-centralisation and soft-budget constraints. The ‘agony of central power,’ or the ‘German problem’ of fiscal federalism, has plagued German federalism through three separate constitutions. Ritschl summarises:

‘Germany’s debt position... is not so much the result of prudence but rather of past misdemeanour and debt forgiveness. Certainly, it is not a measure of the comparative success of German fiscal policy or even the superiority of its social institutions.. there is not a single episode in German debt history since the 1830s in which the ratio of debt to income was reduced by methods other than default.’

The German Reich established in 1871 lacked a sufficient tax base of its own and so depended on transfers from the states – all of which ‘had an incentive to maximise their demands on the centre’s budget.’ Plagued by common-pool incentives, the debt ratio of the Reich increased from around

30% of GDP (1872) to 60% (1914), reaching 130% by 1918.\textsuperscript{2176} In 1920, the Weimar Constitution replaced this with a system of joint taxes collected by the centre and then transferred to the Länder, giving the Bund ‘a virtual monopoly of direct and indirect taxation.’\textsuperscript{2177} However, as predicted by the literature, the Länder became financially dependent on the central level and the Bund was once again plagued by common-pool incentives (including an expensive equalisation system).\textsuperscript{2178} Germany defaulted on its international creditors in 1931 and was released from WWI reparations in 1933, having paid just 12.5% of the amount.\textsuperscript{2179}

After WWII, claims on Germany by Marshall-aid recipients were blocked by US occupation policy until 1953 (and later waived).\textsuperscript{2180} Once again awarded a clean ledger, the Allies insisted on a new tax system in which the Bund and Länder would have authority ‘over only those taxes it needed to meet its responsibilities.’\textsuperscript{2181} They further rejected a fiscal equalisation system, so that the Länder would not fall under the ‘golden harness’ and become dependent on the Bund for revenues.\textsuperscript{2182} However, two threads of the old tendency for German centralisation remained in the 1949 constitution: First, the federation had retained a residual right to tap into Länder direct taxes, making them ‘in effect joint taxes,’ despite this being rejected by the Allies.\textsuperscript{2183} Second, an ambiguous provision stating that the Bund ‘may make grants’ was used to resurrect a fiscal equalisation system.\textsuperscript{2184} Almost immediately, ‘that strongly decentralized model began to be turned into a much more centralized system.’\textsuperscript{2185} Today, there are very few competences in which the Länder are truly autonomous.\textsuperscript{2186}


\textsuperscript{2177} Whereas before the war, expenditures between Bund, Länder and municipalities were 41.9%, 21.8% and 36.21%, by 1929, they were 70%, 10% and 20%, respectively. See: Gerald D Feldman, The Great Disorder (Oxford University Press 1993) 160-161; Gunlicks (2003), 165.


\textsuperscript{2179} Ritschl (1996), 1819. General government debt fell to 40% of GDP in 1933: Burret, Feld and Köhler (2013), 296. Then in 1934, the Länder parliaments ‘ceased to exist as meaningful federal units’ and became administrative units financed wholly by the central government: Gunlicks (2003), 165. See also: Maiken Umbach, German Federalism: Past, Present, Future (Palgrave Macmillan 2002), 123. Art 2 of the Law for the Reconstruction of the Reich of 30 January 34 stated: ‘the sovereign powers of the Länder are transferred to the Reich. The Länder governments are subordinated to the Reich government.’

\textsuperscript{2180} Burret, Feld and Köhler (2013), 296; Ritschl (1996), 19.

\textsuperscript{2181} Gunlicks (2003), 167. Art 109(1)-(2) Grundgesetz (2013) states: ‘The Federation and Länder are autonomous and independent of each other in their budget management,’ giving ‘due regard in their budget management to the requirements of overall economic equilibrium.’

\textsuperscript{2182} Gunlicks (2003), 167

\textsuperscript{2183} Gunlicks (2003), 168.

\textsuperscript{2184} Art 106(4) of the 1949 Constitution read: ‘In order to ensure the working efficiency also of the Laender with low revenues and to equalize the differing burden of expenditure of the Laender, the Federation may make grants and take the funds necessary for this purpose from specific taxes of those accruing to the Laender.’ Gunlicks (2003), 168.

\textsuperscript{2185} Ritschl (1996), 138. Reforms in 1955 and 1969 used these threads to replace the separate taxation powers with joint taxation and extensive fiscal transfers, binding the Länder ‘into arrangements of joint decision making, leaving no room for unilateral exit-options’: Bröschek, 677. See also: Gunlicks (2003), 168-173.

\textsuperscript{2186} E.g., shop opening hours, compensation of their own public servants, and the penal system. Ritschl (1996), 138.
The architecture of contemporary German fiscal federalism is set out under Section X, Articles 104a-115 of the constitution, and is characterised by four main features:

**Shared Revenues:** Article 106 BL divides the tax base between the Bund (Article 106(1), the Länder (Article 106(2)), and joint taxes (Gemeinschaftsteuern) (106(3)). Joint taxes constitute approximately 75% of total revenues, and up to 88% of Länder revenues. Income tax (42.5/42.5%) and corporation tax (50/50) are divided evenly between Länder and Bund, and VAT is divided 52/45.5% in favour of the Bund. Any changes to the tax code require majorities in both the Bundestag and the Bundesrat (State Senate). The alteration of both direct and indirect tax bases are therefore out of control of individual Länder.

**Horizontal Fiscal Equalisation (‘Finanzausgleich’):** Article 106(3) BL establishes a complex system of fiscal transfers which equalises allocated expenditures (fiscal need) with actual revenues (fiscal capacity) to ensure that ‘uniformity of living conditions in the federal territory [is] ensured.’ Need is based on an average figure for all Länder, then adjusted by population size and density. Capacity is determined by the total tax revenues of the Länder, adjusted per capita. Wealthier Länder are then taxed in progressive bands between 15% and 80% of the amount that their per-capita revenue capacity exceeds the average, while poor Länder are entitled to receive subsidies for 100% of the disparity up to 92% of the per-capital average, and 37.5% above that.

**Supplementary Grants (‘Bundeserg ä zungszuweisungen’):** After equalisation, the federal government provides supplementary grants to Länder whose capacity per-inhabitant is less than 99.5% of the average, up to approximately 77.5% of the shortfall. The combination of

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2187 Under Article 106(1) Grundgesetz (2013), the Bund is allocated revenue from customs, excise taxes, road and freight taxes, capital transaction taxes, insurance tax, property levies, and income and corporate surtaxes. Under Article 106(2), the tax base left to the Länder (Ländersteuern) is confined to wealth and inheritance tax, beer tax, motor vehicle tax, property purchase tax, and gaming and casino levies. Article 106(3) provides that income tax, corporation tax, and turnover tax belong jointly to the Federation and the Länder.

2188 See: Groetke and Mause (2012) (estimating 75%); Gunlicks (2003), 176 (estimating 88%).

2189 Direct taxes are divided equally between the Federation and the Länder, while indirect taxes are divided by statute every two years: Bundesministerium der Finanzen, The Federal Financial Equalisation System in Germany (2016).

2190 Art 106(3) states: 1. The Federation and the States have an equal claim to coverage from current revenues of their respective necessary expenditures. […] 2. The coverage requirements of the Federation and of the States are coordinated in such a way that a fair balance is struck, any overburdening of taxpayers precluded, and uniformity of living conditions in the federal territory ensured.’ See also Article 72(2), granting competence to the Federation for ensuring ‘equal living conditions in the federal territory.’ On the system of revenue-sharing, see: Annalisa Fedelino, Sven Jari Stehn, ‘Fiscal Incentive Effects of the German Equalization System’ (2009) IMF Working Paper 124, 7; Gunlicks (2003), 178..

2191 Special adjustments are made for the city states Berlin, Bremen and Hamburg, and the sparsely populated Brandenburg, Mecklenburg-Western Pomerania and Saxony-Anhalt also have a slightly higher financial requirement per inhabitant. Bundesministerium der Finanzen (2016).

2192 Total revenues includes 64% of the sum of receipts of local authorities. Gunlicks (2003), 179.

2193 Bundesministerium der Finanzen (2016)

2194 Art 107(2) of the Basic law states: ‘It has to be ensured by statute, that a reasonable equalisation between financially strong and financially weak Länder is achieved... Such statute may also provide for grants to be made by the federation from federal funds to financially weak Länder in order to complement the coverage of their general financial requirements (supplementary grants).’ The supplementary grants take into account the expenditures and special burdens.
fiscal transfers and supplementary grants assures equalisation to about 98%-99.5% of the German average.\textsuperscript{2195}

**Centralised Debt Brakes:** Since 1969, the Germany has had a constitutional debt brake in the form of a constitutional ‘golden rule’ (no borrowing to fund expenditure). This proved manifestly ineffective, and was replaced in 2009 by a strict balanced budget rule (Article 109(3) BL). It will enter into force for the Länder in 2020.

### 7.2.1.1 Vertical Fiscal Imbalance and Transfer Dependency

Germany is characterised by severe fiscal asymmetry. On the expenditure side, Länder retain significant expenditure autonomy. On average, only 20-25% of expenditures in the Länder are determined by federal laws (15%), including EU legislation and joint Bund/Länder programmes (11-19.5%).\textsuperscript{2196} On the revenue side, however, roughly 75% of the Land’s revenue is provided by joint taxes, the rates and bases of which are determined at national level and split between the Bund and Länder at a pre-determined allocation rate.\textsuperscript{2197} Because the Länder cannot control this tax base, it is, in effect, a massive fiscal transfer from a federal tax.\textsuperscript{2198} The tax base directly controlled by the Ländersteuern under Article 106(2) BL amounts to less than 5% of total tax revenues.\textsuperscript{2199} Since much of this is determined in the Bündesrat, only about 2% of the Länder’s resources could be considered “own revenue” within their discretion.\textsuperscript{2200} The encroachment of federal power on sub-federal tax competences has resulted in what Jochimsen describes as a ‘Gordian knot’ in which ‘every actor has an incentive to let someone else pay their bill while, perversely, incentives for their own activities and effort vanish.’\textsuperscript{2201}

Perhaps unsurprisingly, Rodden finds that the Länder are far and away the most transfer-dependent when compared with other centralised systems such as Australia and Spain, which are in turn more transfer dependent then even the most dependent US States and Canadian provinces.\textsuperscript{2202} Only 44% of the overall revenue of Berlin, for example, come from tax collection (which is in any event shared),

\begin{itemize}
  \item of the Länder, such as above-average public-sector operating costs (e.g., legislative and executive salaries), or burdens associated with unification: Bundesministerium der Finanzen (2016).
  \item Unicredit (2012), 13-15
  \item (Ranging between 11% to 19.5%) In the former states of East Germany, this figure is higher, at approximately 31.9% of all expenditures being drawn from national or EU law. Jochimsen (2008), 547; Groeteke and Mause (2012), 290; Enderlein and Von Müller (2014), 140.
  \item Groeteke and Mause (2012), 291; Jochimsen (2008), 542.
  \item ‘Such “tax sharing” is of course simply an intergovernmental transfer.’ Bird and Tarasov (2004), 81.
  \item Länder tax competences are mainly restricted to: wealth & inheritance, beer tax, motor vehicle tax, property purchase tax, and gaming/casino levies. Federal taxes amount to between 10-20% of the remaining total taxes, and 8% come from Community taxes. Feld and Baskaran (2010), 367; Enderlein and Von Müller (2014), 139.
  \item Fedelino and Stehn (2009), 6.
  \item Beate Jochimsen, 'Fiscal Federalism in Germany: Problems, Proposals and Chances for Fundamental Reforms' (2008) 17 German Politics 541, 552. See also: Jeffery (2003), 22; Enderlein and Von Müller (2014), 35.
  \item Rodden, 'Fiscal Discipline in Federations' (2006), 144, 148. See also: Jeffery (2003).
\end{itemize}
while 28% comes from fiscal transfers.\footnote{This excludes co-financed projects, which would make this latter figure higher. Jochimsen (2008)} According to Mayor of Bremen, a reduction in the share of fiscal transfers to his state would ‘turn out the lights in Bremen.’\footnote{Jeffery (2003), 34.}

Consistent with the ‘flypaper effect,’ these transfers are incredibly distortive.\footnote{As early as 1995, the Federal President noted that the ‘cooperative federalism’ of the German constitution served to perpetuate imbalance and allowed some constituents to make decisions at the expense of other constituents: Uwe Leonardy, 'German Federalism Towards 2000’ in Charlie Jeffery (ed), Recasting German Federalism: The Legacies of Unification (Pinter 1999). See also: Gunlicks (2003), x; Hans Machenstein, Charlie Jeffery, ‘Financial Equalization in the 1990’s: On the Road Back to Karlsruhe?’ in Charlie Jeffery (ed), Recasting German Federalism: The Legacies of Unification (Pinter 1999), 169. Rodden, 'Fiscal Discipline in Federations' (2006), 155.} Transfer-receiving Länder do not reduce primary expenditure in response to rising deficits, and there ‘no indication of adjustment among recipient states at all’ in periods of financial stress.\footnote{Among Länder in receipt of fiscal transfers, Rodden, 'Fiscal Discipline in Federations' (2006), 155 finds, ‘no indication of adjustment among recipient states at all’ and ‘no indication that the recipient states restrain themselves when revenue growth is unexpectedly strong.’} Seitz et al find that net-recipient Länder increase unsustainable budget policies in reliance on fiscal transfers.\footnote{Helmut Seitz, 'Subnational Government Bailouts in Germany' (1999) Zentrum für Europäische Integrationsforschung Working Paper No 20, 10. See also: Fedelino and Stehn (2009), 3.} As Braun concludes: ‘The structural problem behind the opportunistic behaviour of member states is that there is a serious mismatch between available revenues and expenditure tasks.’\footnote{Braun (2007).}

### 7.2.1.2 Expenditure and Revenue Dependence

Since Länder are unable to unilaterally raise revenues, this leaves expenditure cuts.\footnote{Taxes are decided in the Bundesrat, over which individual Länder ‘have little influence.’ Gunlicks (2003), 164. See also: Christian Baretti, Bernd Huber , Karl Lichtblau, 'A Tax on Tax Revenue: The Incentive Effects of Equalizing Transfers: Evidence from Germany' (2002) 9 Int Tax Pub Finan 631.} Yet Länder have little incentive to match expenditures with revenues, because whatever adjustments they make are neutralised by a fiscal transfer scheme that guarantees 99.5% of the overall average per capita tax revenue. Remarkably, Jochimsen finds that the absorption rate of a marginal euro in tax revenue is approximately 90%.\footnote{Paul Bernd Spahn ,Jan Werner, 'Germany at the Junction Between Solidarity and Subsidiarity' in Richard Bird, Robert Ebel (eds), Fiscal Fragmentation in Decentralized Countries: Subsidiarity, Solidarity and Asymmetry (Edward Elgar 2007). IMF, Macro Policy Lessons (2009), 35 finds that that marginal tax rates in Germany are inefficiently high – the tax incentive is broken. See also, Rodden, 'Fiscal Discipline in Federations' (2006), 151: 'By the end of the process, the recipient states actually have similar or even slightly higher revenues per capita at their disposal.’ Feld and Baskaran (2010), 375 point out that recipient states often receive higher per-capita resources than net-contributing Länder.} Simply foregoing the tax rise might ‘buy the government more votes than spending the remaining €0.10 on public goods.’\footnote{Jochimsen (2008), 545. See also: Fedelino and Stehn (2009), 13.} By the reverse token, a rich lander also has diminished incentive to collect a marginal euro in tax, since the extra wealth will increase their payment into the transfer system by 15%-80% of the marginal unit raised.\footnote{Jochimsen (2008), 545.} This ‘kills incentives to run a proper economic policy.’\footnote{Bird and Tarasov (2004), 96; Gunlicks (2003), 179} Jeffery explains:
‘Recipient Länder would always be brought up to around the average fiscal capacity. They had no incentive to improve their economic performance and in that way increase the tax revenues collected on their territory. Boosting fiscal capacity in this way would only mean they received an equivalent drop in equalisation income. At the same time the rich had no great incentive to get richer given that they faced a kind of “marginal tax rate” of 80% once they exceeded 110% of average fiscal capacity.’

Foremny finds that increasing the tax autonomy of Länder to something equivalent to that of Spanish states would reduce deficits by 7.5%, ceteris paribus, while fiscal rules are incapable of doing the same. Feld and Baskaran warn that the new fiscal rule ‘needs to be complemented by tax autonomy for the German Länder’ in order to be effective. Jochimsen agrees:

‘To be meaningful, Länder debt limits have to be introduced along with either more autonomy on the spending side or on revenue collection (or both).’

7.2.1.3 Soft Budget Constraints and Market Discipline

Market discipline is ‘virtually set out of work by the construction of the German fiscal federalism system.’ With over 75% of Länder revenues provided by transfers, the Bund perfectly describes Kornai’s initial provided of capital. Bailouts were constitutionalised in German federalism in 1992, when the BVerfGE interpreted Articles 106 and 107 BL as a federal guarantee of equal living conditions using federal funds, and ordered the Bund to provide financial support amounting to two Länder, Bremen and Saarland, in ‘extreme budgetary distress. Initial financial support amounted to 18% (Bremen) and 22.5% (Saarland) of their expenditures, and the Bund paid supplementary bailout payments to both Länder for the decade between 1993-2004. An OECD Economics Department paper notes:

‘Constitutional [rules] can weaken incentives for sub-central governments to behave prudently. The most egregious example of this is the constitutional ruling in Germany that requires the federal government to provide financial support to the heavily indebted Länder of Saarland and Bremen. The consequences of this ruling make it nearly impossible for central government to resist bailouts in the future.’

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2214 Jeffery (2003), 30.
2216 Feld and Baskaran (2010).
2217 Jochimsen (2008), 552.
2218 Groeteke and Mause (2012), 291. See also: Rodden, 'Fiscal Discipline in Federations' (2006), 138-143.
2219 This is particularly so since the Bund does not simply transfer revenues – it has a direct hand in administering them through cost-sharing programs. For example, the Bund is responsible for 50% of the cost of higher education, 50% of regional development, 60% of agriculture support, and 70% of shoreline preservation. Bird and Tarasov (2004), 95.
2220 BVerfGE 86, 148-Finanzausgleich II, 32. For a detailed discussion of the judgment, see: Seitz (1999).
2221 Jochimsen (2008), 546; Fedelino and Stehn (2009), 9-10.
2222 Sutherland, Price and Joumard (2005), 36.
As it presently stands, German Länder simply ‘cannot go bankrupt.’ Investors ceased to apply differentiated default risk to Länder following the Saarland/Bremen ruling. Fitch merged all Länder ratings into the rating of the Bund, citing the Saarland/Bremen ruling for the proposition that no German state would be allowed to default so long as the Bund is solvent. S&P and Moody’s still rate Länder separately, however all sixteen Länder enjoy an Aa1 rating or above, despite wildly different ‘base risk’ calculations. Institutional investors have followed suit. As UniCredit states: ‘The fact that the four German states have very high debt levels is old hat... a German state cannot fail to fulfill its financial obligations unless the Bund and the other states are no longer able to provide financial assistance.’

Rodden finds that, with average debt-to-own revenue ratios of nearly 2000%, the German Länder ‘would not be creditworthy if their debt burdens were assessed relative to their own meagre taxes.’ Empirical work by Schulz and Wolff, Enderlein and von Müllen and Baskaran, all conclude that several German Länder are functionally bankrupt, and Länder bond yields are completely disconnected from important indicators of risk. Empirical work by Heppke-Falk and Wolf finds that higher interest-revenue ratios are now associated with decreasing marginal interest-rates, as Länder in poor fiscal health get closer to ‘qualifying’ for a bailout.

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2223 Jochimsen (2008), 550: when Länder ‘cannot afford to pay their civil servants or to service their debt, they are bailed out by the federal government.’ See also: Kirsten Heppke-Falk, Guntram Wolff, ‘Moral Hazard and Bail-Out in Fiscal Federations: Evidence for the German Länder’ (2008) 61 KYKLOS 425, 440. Enderlein and Von Müller (2014), 153: ‘as long as the German constitution can be read as requiring the federation to bail out Länder in fiscal distress, threats by the federation to allow Länder to enter into a default or debt restructuring with private creditors have extremely limited scope.’

2224 Rodden, 'Fiscal Discipline in Federations' (2006), 146: today, ‘rating agencies attach relatively little weight to local fiscal and economic outcomes.’ See also: Enderlein and Von Müller (2014), 140 the 1988 ruling confirmed that the Bund would ‘serve as universal and unconditional lender of last resort to distressed Länder.’

2225 Seitz (1999), 21; Unicredit (2012), 16.

2226 Both agencies cite the federal bailout guarantee. Moody’s assesses the baseline credit risk of Länder individually, but then factors in the default dependence and likelihood of a bailout. Although the base risk of German Lander ranges from 2 in Bavaria and 5 for Berlin, Saarland and North-Rhine Westfalia, none of those Länder receive less than an Aa1 rating due to the high likelihood of a bailout. S&P see a bailout of a state’s liabilities in capital markets as not automatic and contingent on negotiations. For an accessible summary of S&P ratings, see: Unicredit (2012), 3-9. Groeteke and Mause (2012), 292.

2227 Unicredit (2012), 6, 19: since ‘all 16 German states enjoy very strong support from the German sovereign’ any differences in spreads are not a risk, but ‘a buying opportunity.’

2228 Rodden, 'Handbook of German States (UniCredit), 19.

2229 Rodden, 'Fiscal Discipline in Federations' (2006), 150.


2231 Enderlein and Von Müller (2014), 135: ‘market participants still believe that there is a clear bailout guarantee.’

2232 Baskaran (2011), 124, a study of strategic interactions in German panel data from 1975 to 2005 concluding that state governments ‘believed that there was the distinct possibility of a bailout during that period.’


2234 Heppke-Falk and Wolff (2008), note (at 434) that the court ‘indicated to financial markets that Länder with large interest-to-revenue ratios are in fact less risky.’ See also: Jochimsen (2008), 546: ‘This is fatal because it eliminates the incentives for these Länder to reform their budgets. Instead of making unpopular budget cuts to lower public deficits, they can just wait until their Land has enough debt accumulated [for a bailout].’
7.2.1.4 Fiscal Rules

Germany has had a balanced-budget ‘golden investment rule,’ applicable to both Bund and Länder, enshrined in its constitution since 1969. The German debt brake conforms to the strictest kind of debt brake identified by the literature. And yet, it has proved useless in the face of soft budget constraints. Between 1991 and 2005, the golden-rule debt limits were exceeded 68 times by the Länder and seven times by the Bund. The debt-to-GDP ratio of the Länder increased 250% from 1975 (10%) to 2005 (25%). In seven out of twelve years from 1999-2010, Germany violated the 3% debt-to-GDP ratio of the SGP, and in eleven out of twelve of those years, the general government debt ratio exceeded 60%. Germany continues to finance an increasing proportion of its activities by issuing debt in financial markets, and spends far less on investment than it did prior to 1999. Groeteke and Mause observe:

‘Without regular fiscal transfers and extraordinary bailout payments, [several] states would be bankrupt ... As long as this high bailout likelihood exists, neither the 2009 debt brake nor the credit-market brake are likely to have a disciplining effect on states’ debt polices.

Where the fiscal rule was not violated, it was circumvented. Kirchhoff points out that an exception to the rule in the event of a ‘disturbance of the overall equilibrium’ has been activated every year since 1970. Legal enforcement also proved futile: On those occasions were a budget was successfully challenged, the borrowing and expenditure commitments could not be revoked retroactively or were no longer in effect. Indeed, the BVerfGE’s Saarland/Bremen ruling ordered

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2235 This prohibits operating deficits but permits borrowing for investment. Art 110 BL stated: ‘Revenue obtained by borrowing shall not exceed the total of investment expenditures provided for in the budget.’ Art 115 BL applies to the Länder, and states: ‘Revenue and expenditure are principally to be balanced without revenues from credits. [2] This principle is satisfied if revenues from credits do not exceed 0.35 percent in relation to the nominal gross domestic product.’

2236 Groeteke and Mause (2012), 285. See also John McEldowney, 'Debt Limits in German Constitutional Law - A UK Perspective' in Wolf-Georg Ringe, Peter M Huber (eds), Bail-outs, the Euro and Regulation (Hart Publishing 2014) 63.

2237 Baskaran (2011), 117.

2238 Groeteke and Mause (2012), 290.

2239 Bond-financing as a share of debt has doubled since 2001, from 25% to 50% by the end of 2011. Unicredit (2012), 3.


2241 Groeteke and Mause (2012), 295.

2242 Kennedy and Robbins (2001), 8. Judicious use was made of escape clauses to ‘avert a disturbance of macroeconomic equilibrium’ (an exception written into the federal constitution and 13 of 16 state constitutions) or ‘extraordinary need’ (the remaining three state constitutions): Groeteke and Mause (2012), 285. This was aggravated because decisions on the recognition of emergencies were often under the control of parliaments ‘where the executive and ‘its’ parliamentary majority normally tend to seek the very same policy objectives: Delledonne (2014), 186.

2243 Clearly, this ‘cannot possibly have been valid over a period of 40 years.’ Kirchhof (2014), 56.

2244 For example, the 2002-2003 Berlin Budget was declared unconstitutional on 31 October 2003, with the only consequence being that no new projects could be initiated in the final two months: Jochimsen (2008), 547. Public scrutiny by the Finanzplanungsrat, a Bund/Länder oversight committee that ‘could and should’ have functioned like an independent body also ‘faded away unheard’: Jochimsen (2008), 548. See also: Seitz (1999).
assistance while recognising that both those Länder had violated the Basic Law for fifteen consecutive years.\textsuperscript{2245} Jochimsen observes:

‘Landers politicians face strong incentives to finance public expenditures via debts because they know that, in the end, there will be a bailout. Existing rules to prevent over-indebtedness of the Bund or the Länder have proved to be nothing but a paper tiger.’\textsuperscript{2246}

In 2009, Germany replaced its ‘golden rule’ with a strict balanced-budget ‘debt brake’ (Schuldenbremse). A structurally-balanced deficit of 0.35% of GDP must be achieved ‘without revenue from credits’ by the Bund by the end of 2015, and by 2020 for the Länder.\textsuperscript{2247} The Schuldenbremse is not in effect until 2020, however economists have already begun to point out many endogenous flaws shared with its ineffectual predecessor: Numerous ‘gladly used’ creative accounting avenues remain open,\textsuperscript{2248} and an in-built escape clause for economic deviations from ‘normal conditions’ apes the ‘disturbance of the overall equilibrium’ escape- clause activated every year for the past 40 years.\textsuperscript{2249} Groeteke and Mause conclude:

‘Overall, the analysis of a number of crucial design issues suggest that the 2009 German debt brake is actually not a credible commitment to slow down or stop the ‘drive’ further into public debt. . . These issues will appear in all European countries which copy the German debt brake as agreed in the 2012 EU “Fiscal Compact”.’\textsuperscript{2250}

\textsuperscript{2245} BVerfGE 86, 148-Finanzausgleich II. See: Seitz (1999), 16; Rodden, 'Fiscal Discipline in Federations' (2006), 154 (finding that long-term deficit and debt positions are correlated with the likelihood of a bailout, not the debt brake).

\textsuperscript{2246} Jochimsen (2008).

\textsuperscript{2247} Unplanned deficits and surpluses are registered to a ‘control account’, which must be balanced over the medium-term. Article 109(3) BL states: ‘The budgets of the Federation and the Länder shall in principle be balanced without revenue from credits. The Federation and Länder may introduce rules intended to take into account, symmetrically in times of upswing and downswing, the effects of market developments that deviate from normal conditions, as well as exceptions for natural disasters or unusual emergency situations beyond governmental control and substantially harmful to the state’s financial capacity. For such exceptional regimes, a corresponding amortisation plan must be adopted. Details for the budget of the Federation shall be governed by Article 115 with the proviso that the first sentence shall be deemed to be satisfied if revenue from credits does not exceed .35 percent in relation to the nominal gross domestic product. The Länder themselves shall regulate details for the budgets within the framework of their constitutional powers, the proviso being that the first sentence shall only be deemed to be satisfied if no revenue from credits is admitted.’ The new debt brake concerns the structural balance, and therefore accounts for cyclical oscillation, using macroeconomic models used at EU level: Article 115(5) BL Grundgesetz (2013).

\textsuperscript{2248} Borrowing by public enterprises and public banks is not covered by the new budgetary rules, nor is ‘implicit borrowing’ (commitments to future pension/health expenditures), social security, or municipal borrowing. Circumvention strategies such as PPPs, Sale and Lease-back arrangements, and shifting debts to existing ‘Federal Special Funds’ remain open. Groeteke and Mause (2012), 285; Feld and Baskaran (2010).

\textsuperscript{2249} Kirchhof (2014), 56, 60. Given that, as Groeteke and Mause (2012), 284 note, in just three years since 1945 (1966, 1972 and 1982) has a government not possessed a majority in the Bundestag, this would seem an exceptionally easy mechanism to subvert. Feld and Baskaran (2010), 385; Fedelino and Stehn (2009), 9-10 point out that another exemption - in the event of ‘natural disasters or unusual emergency situations beyond governmental control and substantially harmful to the state’s financial capacity’ – is problematic, since the bailouts of Saarland and Bremen followed on from the BVerfGE’s acceptance that their debts were the result of ‘adverse economic developments outside their control.’

\textsuperscript{2250} Groeteke and Mause (2012), 289-290.
7.2.1.5 Evaluation of Outcomes

The German ‘surveillance’ model of fiscal federalism (shared revenues, fiscal transfers, bailouts, and constitutional debt brakes) is an empirical failure.2251 By 2000, the gap in competitiveness and wealth between ‘rich’ and ‘poor’ Länder had become ‘far greater than anything known before unification.’2252 The 1969 debt rule has presided over ‘a systemic upward-ratcheting of subnational debt,’2253 and the Länder are plagued by ‘a long-term structural debt problem.’2254 Germany’s aggregate gross debt-to-GDP ratio increased by nearly 300% from 1970 (18.6%) to 2009 (73% of GDP).2255 Prior to the 2008 financial crisis, 12 of 16 Länder had deficits breaching the constitutional rule, and three were in a state of emergency.2256 At the time of writing, Bremen, Saarland and Schleswig-Holstein remain in a state of budgetary crisis.2257 In 2015, the Stability Council found that ‘Overall, a quarter of the Länder continue to face major challenges in order to achieve compliance with the debt ceiling in 2020,’2258 ‘Given the magnitude of this debt,’ Kirchhoff concludes, ‘it is surprising that public finances in Germany are regarded as sound.’2259 The German model, of bailouts + legal debt brakes, is a theoretical and empirical failure.

7.2.2 The Swiss Confederation

The Swiss Confederation is a highly decentralised, extremely heterogeneous federation that evinces all the characteristics of the ‘ideal’ type of market-preserving federalism: [7.2.2.2] The allocation of

\[\text{\textcolor{red}{2251}}\text{Braun (2007): ‘Germany… is considered as highly inefficient and that demonstrates several failures with regard to our rules [of fiscal federalism]: there are no hard budget constraints; there is a collectively organised bail out system; there are strong incentives for rent-seeking; there are chances for the federal government to use predatory behaviour; connectivity between revenues and expenditures is not respected.’ Machenstein and Jeffery (1999) 155 observing ‘persistent, structural problems inherent in the operation of the equalization process and, more broadly, of German federalism per se.’}\]

\[\text{\textcolor{red}{2252}}\text{Machenstein and Jeffery (1999), 169. See also: Feld and Baskaran (2010), 370.}\]

\[\text{\textcolor{red}{2253}}\text{Feld and Baskaran (2011), 124.}\]

\[\text{\textcolor{red}{2254}}\text{Feld and Baskaran (2010), 370.}\]

\[\text{\textcolor{red}{2255}}\text{Feld and Baskaran (2010), 370. Kirchhof (2014) finds that explicit government debt increased from €63bn in 1970 to over €2,000 billion in 2011, excluding implicit liabilities from pensions and social security which exceed this number by a factor of two to four. Even Germany’s Maastricht consolidation phase was achieved without any contribution from the Länder: Fedelino and Stehn (2009), 11.}\]

\[\text{\textcolor{red}{2256}}\text{Braun (2007).}\]


\[\text{\textcolor{red}{2258}}\text{This was so ‘despite very favourable effects on public finances from very low interest rates, strong bubbling sources of tax revenue and a favourable labour market situation.’ Beirat des Stabilitätsrats, 'Second Opinion to comply with the ceiling for the structural general government deficit according to §51 paragraph 2 Stability Council Law' (Advisory Council of the Stability Council). An additional number violate sub-thresholds established by the stability council, such as the ratio of tax revenue to interest payments (Berlin), debt per capita (Berlin, Saxony-Anhalt), structural deficit per capita (Hamburg), and a limit on the percentage of debt-financed expenditures (Hesse, Rhineland-Palatine). Enderlein and Von Müller (2014), 134. The Commission has been highly critical of new fiscal rules in the Länder: Commission, ‘Recommendation of 29 May 2013 on Germany’s national reform programme’ COM(2013) 355 final.}\]

\[\text{\textcolor{red}{2259}}\text{Kirchhof (2014), 54.}\]
expenditure and revenues between the Cantons and the Federal Council is symmetrical; [7.2.2.1] Swiss Cantons have total control over their own tax base and rates, with constitutional protection against predation by the Federal Council; [7.2.2.4] Cantonal finances are subject to no federal oversight or borrowing restrictions; and [7.2.2.3] Cantons are subject to a hard budget constraint under a credible ‘no bailout’ rule.\textsuperscript{2260} As predicted by the literature, Switzerland has a long history of fiscal discipline. When the crisis arrived in 2008, 24 of 26 Swiss Canton were in surplus (two had deficits of <1%), and no Swiss Canton has ever defaulted or been bailed-out by the Confederation.\textsuperscript{2261}

7.2.2.1 Expenditure and Revenue Autonomy

On the expenditure side, Cantons are responsible for over 60% of total expenditures in Switzerland, and federal legislation impacts on few Cantonal spending responsibilities.\textsuperscript{2262} On the revenue side, the Swiss Constitution allocates corporate and personal tax to the Cantons, and these taxes account for 95\% of their total tax revenue.\textsuperscript{2263} Moreover, all taxes not specifically assigned belong to the Cantons under the constitution, so there is no possibility of federal encroachment.\textsuperscript{2264} Cantons set their own bases and rates, and unfettered tax competition is seen as ‘an important asset for the international competitiveness of the country.’\textsuperscript{2265} Because tax competition keeps taxes low, fiscal adjustments most often take the form of expenditure cuts (though temporary tax increases are common).\textsuperscript{2266}

7.2.2.2 Vertical Fiscal Symmetry

Switzerland evinces a high degree of fiscal symmetry. Areas of joint responsibility are small and progressively decreasing: falling from 50 parallel competences to 21 between 2004 and 2013.\textsuperscript{2267} Importantly, conditional grants have been entirely eliminated, removing the federal ‘golden leash’ incentive to intervene in state expenditures.\textsuperscript{2268} A 2004 reform of Swiss fiscal federalism eliminated these fiscal asymmetries in two ways.\textsuperscript{2269} First, 29 of 50 shared responsibilities were dis-entangled,
21 of which were returned to the Cantons. Second, earmarked transfers which had crept in to Swiss Federalism over the preceding decades were virtually eliminated and replaced with a new equalisation system (‘Neuer Finanzausgleich’), which has largely swapped incentive-sapping expenditure grants with ex-ante capacity equalisation.

The Neuer Finanzausgleich aims to equalise Cantonal resources to 85% of the average tax potential. Unlike the previous system, expenditures and actual revenues are no longer part of the formula for assessing entitlements for resource equalisation (‘Ressorcenausgleich’). The new calculation takes into effect only potential revenues of the cantons, according to a basket of the main tax bases belonging to the Cantons. This moves away from German Federation - based on actual expenditures, and closer to the Canadian system – based on the potential tax base. In so doing, it preserves incentives to raise a marginal unit of capital, since Cantonal transfer obligations or entitlements will not rise or fall with actual tax receipts. Furthermore, where equalisation payments previously came from the centre, transfers are now horizontal, with the eight richest Cantons contributing approximately 70% of the amount. This withdraws the hand of the centre from the position of Kornai’s provider of capital and transfers it to the Cantons, who are not vulnerable to that incentive because their obligations can no longer rise or fall on the basis of marginal revenues raised. Only one aspect of the old transfer system remains: because 85% of tax potential is a guaranteed minimum, the federal government will supply the difference if Cantons are still not at 85% after horizontal transfers. However, as this liability is capped to 85% of average potential, the scheme still redistributes far fewer marginal resources than the German system.

### 7.2.2.3 Hard Budget Constraints and Market Discipline

Swiss Cantons operate under hard budget constraints. This was tested at Cantonal level in the mid-1990’s, when a succession of Cantons came under market pressure for the implicit liabilities of cantonal banks and were refused bailouts; and again in the Leukerbad (Switzerland) case, wherein the Supreme Court upheld Valais’ right to reject a bailout demand from Leukerbad. As a result, ‘lenders have been forced to evaluate the creditworthiness of public debtors.’ Ratings agencies assess each Canton separately, and bond markets exert strong pressure on Cantonal and municipal

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2270 Braun (2007): ‘Both predatory behaviour and rent-seeking have been part of Swiss fiscal federalism until recently.’

2271 Art 136 Federal Constitution of the Swiss Confederation; Stalder and Röhrs (2005),15. Some remnants of old system remain. First, there is a temporary cohesion fund (‘Härteausgleich’) which compensates Cantons which lose funds as a result of the changes to an amount equal to the sum it received prior to the amendment. (In 2012 a digression clause kicked in to reduce this amount by 5% per annum.) Second, the reforms have not done-away with cost-equalisation transfers (‘Lastenausgleich’) designed to reduce financial inequalities arising from external factors (such as topography) or from special financial burdens from which other jurisdictions profit (such as hospitals). Feld and Baskaran (2010), 381.

2272 Braun (2007).

2273 A Canton will not receive more money for being poor at optimizing its tax base: Feld and Baskaran (2010), 381.


2275 Feld and Baskaran (2010), 379.
The IMF notes that markets track debt patterns of cantons closely, and debt differentials, and political spending commitments are priced into financing rates.  

7.2.2.4 Fiscal Rules and Fiscal Outcomes: An Evaluation

No centrally-imposed fiscal rules apply to Swiss Cantons. Cantons are entirely autonomous in the realm of fiscal policy. However, competition for investment and public preferences have produced a heterogeneous array of governance adaptations within the cantons themselves.

A first group of Cantons, Fribourg, Nidwalden, St. Gallen, Solothurn, and Zürich, have developed relatively strict balanced-budget rules accompanied by a strong sanctioning mechanisms, ranging from automatic expenditure-linked tax increases (Solothurn), to automatic carry-overs (Nidwalden). A second group of Cantons, Aargau, Berne, Graubünden, Lucerne and Valais, have cyclical BBRs enforced by automatic carry-over rules. A third group of cantons (Appenzell, Ausserhoden, Basel Stadt and Ticino) have only weak rules in place, while the largest group - Neuchâtel, Schwyz, Appensell Innerhoden, Basel, Geneva, Glarus, Obwalden, Schaffhausen, Thurgau, Uri Vaud, Zug and Jura - have no fiscal rules at all.

These rules are found to correlate with positive fiscal outcomes. Stalder and Rohs, for example, find that Cantons with strict debt brakes are more effective at smoothing spending over the economic cycle than Cantons with no debt brakes, and Feld et al find that stronger rules are rewarded with lower bond yields.

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2276 IMF, 'Switzerland 2012' (2012), 35 notes that markets track debt patterns of cantons closely, and debt differentials, and political spending commitments are priced into financing rates. See also: Stalder and Röhrs (2005), 18.


2278 Switzerland also introduced a constitutional debt brake at the federal level in 2003. This has coincided with fall in the general government debt ratio of 15% from 2003-2010, but commentators mainly attribute this to ‘favourable economic trends.' See: McEldowney (2014), 68; Stalder and Röhrs (2005), 3. See: Arts 126, 159 BV BB1 2000 4653.

2279 Only of these Cantons allow for cyclical deviations with respect to the business cycle, and only in Solothurn can the sanction be avoided (upon 2/3 majority). The numerical constraints consist of BBRs (in Fribourg and Zürich), deficit limits linked to earnings (St. Gallen), expenditures (Solothurn), and a three-year mean (Nidwalden). St Gallen’s debt brake is arguably the most strict. The deficit cannot exceed 3% of the ‘simple tax’ (income and wealth tax), and surpluses must be applied to a buffer capacity seven times the permissible deficit before taxes can be reduced. Stalder and Röhrs (2005), 3; Feld and Baskaran (2010), 378-379.

2280 Only in Valais is there an escape clause (also upon a 2/3 majority). The numerical constraints consist of a balanced budgets (in Fribourg and Zürich), deficit limits linked to earnings (St. Gallen), expenditures (Solothurn), and a three-year mean (Nidwalden). St Gallen’s debt brake is arguably the most strict. The deficit cannot exceed 3% of the ‘simple tax’ (income and wealth tax), and surpluses must be applied to a buffer capacity seven times the permissible deficit before taxes can be reduced. Eyraud and Gomez Sirera (2014); Stalder and Röhrs (2005), 3; Feld and Baskaran (2010), 378-379.

2281 The rules in the weak group typically attempt to limit the growth of expenditure (excepting Appenzell, which limits the deficit), but all allow for a correction for the business cycle. Sanctions are relatively light, requiring amortisation of over future budgets. Stalder and Röhrs (2005), 3, Appendix A.

2282 Stalder and Röhrs (2005), Appendix A.

2283 Stalder and Röhrs (2005).

2284 Feld, Kalb and Osterloh (2013): the existence of a numerical fiscal rule is rewarded with a yield spread, on average, 17bps lower than Cantons with no fiscal rules.
Is this to say that fiscal rules responsible for the stability of Swiss Federalism? Hardly. Bond yields are also correlated with language, for example, even if institutions are held constant. Empirical evidence typically attributes Swiss rectitude to market discipline and voter preference. Stalder and Röhrs’ report to the OECD is typical: ‘Fiscal rules had no influence on the spending patterns of the cantons and communes.’ The IMF concludes, for this section:

‘The Swiss system of fiscal federalism is working well. To summarise, a rationalised system of intergovernmental fiscal relations (including clear task assignments, rationalised equalization flows, a no-bail-out presumption, and a considerable degree of tax autonomy) has delivered a general culture of fiscal discipline and laid the basis for a credible commitment to and consistent compliance with fiscal rules.’

7.2.3 The United States of America

The United States of America is another highly decentralised federation that evinces all the characteristics of the ‘ideal’ type of fiscal federalism: [7.2.3.1] There is clear vertical fiscal symmetry between state and federal governments; [7.2.3.2] there are no federal constraints on state budgets; and [7.2.3.3] bond markets exert strong pressure on state finances.

American federalism is particularly relevant to the EU, for three reasons: First, there is no federal transfer system in the US. This makes it unique among the federations in this chapter. Second, much like the EU, until the 1930’s the US federal budget as a percentage of aggregate GDP was extremely small, amounting to just 2-3% of GDP. Third, the US began its life under an implicit bailout expectation, but managed to switch its federal ‘type’ partway through its history: The first period of American federalism, from 1790-1842, began with the assumption of state war debts, was characterised by soft budget constraints, and ended with a wave of state defaults. The second period, from 1842 to the present, began when the Federal Congress took costly action to restore hard budget constraints, refusing to bail out state infrastructure debts. This caused nine state defaults (Arkansas, Illinois, Indiana, Louisiana, Maryland, Michigan, Mississippi, Pennsylvania and Florida), and impaired market access for a further four (Alabama, New York, Ohio, Tennessee). Yet today, this

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2285 Fiscal outcomes and bond yields correspond to variables such as cantonal referenda and language, which provide useful proxies for voter preferences in the Swiss context. See, e.g., Dominique Küttel, Peter Kugler, 'Explaining Yield Spreads of Swiss Canton Bonds: An Empirical Investigation' (2008) 16 FMPM 208 (Latin cantons pay higher rates than German-speaking cantons, even if fiscal and institutional factors are controlled).


episode is credited with nearly two centuries of state financial stability and the dollar’s status as the world’s reserve currency. The lessons for EMU are obvious, and the comparison widely noted.

7.2.3.1 Vertical Fiscal Symmetry

Like the EU, the US federal budget has historically been extremely small. However, unlike the EU, the American budget has developed within independent federal public goods (such as national defence and other collective goods), with no role for fiscal transfers or bailouts. Today, there is a high degree of fiscal symmetry and no federal equalisation program in the US. The federal spending power does play a natural countercyclical role, but any federal redistributions arise only de facto, within federal responsibilities themselves (federal social programmes, such as Medicaid, account for personal incomes in the states, and so are inherently redistributive). O’Rourke and Taylor note that for every $1 income loss at state level, ε28 are borne by the federal government. Other estimates of regional stabilisation by federal programmes range from 40% of income loss, to less than 10% of state GDP.

It remains, however, that because equalisation formulae are confined within federal spending competences, fiscal symmetry is maintained: ‘they do not relieve state and local governments of debt obligations.’

7.2.3.2 Revenue and Expenditure Autonomy

In principle, the US Constitution would seem ripe for ‘golden leash’ predations of state competences: The federal competence to spend in the ‘general welfare’ under Section 8 of the US Constitution has

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2292 Henning and Kessler (2012): ‘For better or worse, the US remains our ultimate policy laboratory.’

2293 2-3% of GDP until the 1930’s, compared to around 1% in the EU. Dabrowski (2015), 9.


2297 Xavier Sala-i-Martin, Jeffrey Sachs, 'Fiscal Federalism and Optimum Currency Areas: Evidence for Europe from the United States' in Matthew Canzoneri, Vittorio Grilli, Paul Masson (eds), Establishing a Central Bank: Issues in Europe and lessons from the US (Cambridge University Press 2008) (finding a decrease in federal taxes by ε34 and an increase in federal transfers of $6 per $1 in income loss.)


been interpreted to include spending in areas that would be outwith the federal legislative power.\textsuperscript{2300} However, US states have near-complete revenue and expenditure autonomy, and tax competition is a powerful driver of US competitiveness. This is largely due to a strong institutional authority in the form of the US Supreme Court, which conceives of US states as miniature sovereign polities exercising sovereign revenue and tax powers.\textsuperscript{2301} As stated by Kennedy J in \textit{US Term Limits v Thornton}:

‘Federalism was our nation’s own discovery. The Framers split the atom of sovereignty. It was the genius of their idea that our citizens would have two political capacities, one state and one federal, each protected from incursion by the other.’\textsuperscript{2302}

The US Supreme Court has traditionally guarded against vertical asymmetries by pruning federal conditionality back to the objectives of federal competences. In \textit{New York v US}, for example, the Supreme Court held that the federal government could not directly interfere with the fiscal autonomy of a state by tying budgetary conditions to a substantive federal spending programme.\textsuperscript{2303} Similarly, in \textit{NFIB v Sebelius}, the Supreme Court foreclosed the use of the ‘general welfare’ competence to co-opt state fiscal competences by striking-down conditionality attached to a Medicare grant that penalised non-compliance with loss of all existing Medicaid funding.\textsuperscript{2304} Put simply, the Federal Government and US States may make co-investments for the achievement of specific objectives, but the Federal Government cannot attach conditions which require states to implement policies in areas of their own competence.\textsuperscript{2305} EU bailout programmes like that at issue in \textit{Dowling v Minister for Finance}, or Council Decision 2010/32/EU, which tie transfers to the implementation of policies outside EU competence, would be unconstitutional in the US.\textsuperscript{2306}

\subsection*{7.2.3.3 Hard Budget Constraints and Market Discipline}

From 1790-1842, US federalism was characterised by implicit bailout expectations, soft budget constraints, and state budgetary instability. The Federal Congress established in 1788 inherited $52m in Continental Congress debts from the War of Independence, in addition to $25 held by the US states – a volume amounting to 40\% of GDP.\textsuperscript{2307} With no equivalent means of taxation, in 1790 the

\begin{footnotesize}\begin{itemize}
\item\textsuperscript{2301} \textit{Hans v Louisiana} [1890] 34 US 1 (US Supreme Court). See: Peterson and Nadler (2014).
\item\textsuperscript{2302} \textit{US Term Limits Inc v Thornton} [1995] 514 US 779 (US Supreme Court).
\item\textsuperscript{2303} \textit{New York v United States} [1992] 505 US (US Supreme Court), 176-177,
\item\textsuperscript{2304} \textit{National Federation of Independent Business v Sebelius} [2012] 567 US (US Supreme Court). See also: \textit{US v Butler}.
\item\textsuperscript{2305} Several states rejected conditional transfers in the 2009 stimulus for this reason: Braun and Trein (2014).
\item\textsuperscript{2306} See: Section 8.5.3, pp 223-223. Case C-41/15 \textit{Dowling v Minister for Finance} (Opinion of AG Wahl) [25]; Case C-41/15 \textit{Dowling} (reference of 21 February 2015) [41.2](4). For this point: Fabbrini (2013), 29.
\end{itemize}\end{footnotesize}

This allowed the Federal Congress to credibly back its own debt issues, but it also had an unintended secondary effect: Soft budget constraints.\footnote{Alexander Hamilton, \textit{Report on Public Credit} (Vol. 6, 1790). The objective of establishing a financing market for federal bonds required that repayment of its foreign debts be treated as a ‘sacred obligation [to be] paid in full.’ This required revenues. Hamilton’s proposal sought to tie States to the economic fortunes of the new Congress, increasing federal influence and reducing state dominance: Miller (1960), 37. See also: Staloff (2005), 96.} As Henning and Kessler summarise, from 1790-1836 (when the Federal Congress assumed the debts of the District of Columbia), ‘the possibility of a federal bailout of states was a reasonable expectation; moral hazard was substantially present.’\footnote{Other hints of a bailout abounded: The states received federal assistance in the form of revenue and lands; federal surpluses were used to fund public works in the states; the federal government again assumed the war debts of states after the War of 1812; and then assumed the debts of the District of Columbia in 1836. See: Henning and Kessler (2012), 10.} As is now familiar to the literature, this precipitated a wave of unsustainable borrowing. Between 1820 and 1842, state debts increased from $4 million (1820) to $232 million (1843) – an increase of 5,700%.\footnote{English (1996), 161 finds that, for example, over $22m of Pennsylvania’s $35m debt in 1842 was held by England, Holland and France; 50% of Florida’s and Arkansas’ debts were held in Amsterdam or London; 20% of New York’s debt was held in Europe; Mississippi’s governor claimed that 100% of its debt was held by foreigners in 1840; much of Illinois’ debt was held in London; and nearly 50% of Maryland’s debt, over 66% of Georgia’s debt, 70% of Mississippi’s debt, and over 90% of Louisiana’s debt were payable in London. See also: Adams (1890), 318; Wallis (2005), 216; Sargent (2012), 24; Henning and Kessler (2012) 10. Rodden, ‘Can Market Discipline Survive?’ (2014); Van Malleghem (2014), 154.} By 1842, four US states (Virginia, Pennsylvania, Maryland and Ohio) faced insolvency and, citing the precedent of 1790, proposed that $200,000,000 of federal stock should be exchange for state securities.\footnote{Adams (1890), 33, noting that the state were supported by creditors ‘who would gladly have thrown the burden of their debts on the shoulders of Congress.’ See also: Sargent (2012), 25.} Adams, \textit{Public Debt} (1890) observes:

‘The important point for us to notice is, that the plan for assuming the State debts in 1842 finds its historical antecedent in the various distribution schemes then familiar to the members of Congress.’\footnote{Adams (1890), 334. Indeed, this line of argument was pursued directly in Congress, where the states argued that ‘The Constitution is the same now as then; Congress is the same now as then; and it can exercise as wise, as enlarged and as liberal a discretion now as then.’ … [T]he States have a right to demand a reimbursement, in this period of their utmost need, of the sum used by the government for its own national purposes.’ (As recited in Adams, pp 319, 333).} The important point for us to notice is, that the plan for assuming the State debts in 1842 finds its historical antecedent in the various distribution schemes then familiar to the members of Congress.

Yet this time, the bailout was denied. The immediate consequences were costly: Eight states (Arkansas, Illinois, Indiana, Louisiana, Maryland, Michigan, Mississippi, Pennsylvania and Florida) defaulted on their debts.\footnote{Grinath III and Wallis (1997); Wallis (2005).} Of these, five (Arkansas, Florida, Louisiana, Michigan, Mississippi) later repudiated all or some of their debts ($12,770,000 in total), and four states were forced to renegotiate with their creditors (Illinois, Indiana, Maryland, Pennsylvania).\footnote{BU Ratchford, American State Debts (Duke University Press 1941), 114.} A further four states (Alabama,
New York, Ohio, Tennessee) narrowly escaped default. Of the nineteen states which did not face default, twelve had debts that were on an unsustainable growth trajectory.

The 1842 episode may ‘be properly regarded as marking an epoch in the constitutional development of the States.’ By the end of the decade, over half of US states had enacted budget laws in order to get back in good with markets, and most undertook difficult reforms, innovating with their own tax bases and setting-off the inter-state tax competition which still characterises US federalism. Nearly two centuries later, markets still monitor state finances closely and exhibit significant price sensitivity to risk (particularly gross debt) in a manner that impels states to act consistently with their solvency. Between 2001-2007, the average spread between US states was wider than the bond spreads between EU states – despite much narrower debt dispersion characteristics. Spillovers are also few: A deterioration in one state’s credit outlook does not cause a deterioration in other states. In other words, the US struggled out of precisely the bailout trap that the EU has now fallen. Sargent explains:

‘[T]hat decision succeeded in establishing a strong reputation of the federal government vis-à-vis the states… To put the point bluntly, if by bailout of those state debts for the federal government had set up expectations that it would back up state loans in the future… That will almost surely put the government into the position of eventually having to bail them out again. […] [I]n exchange for offering such insurance, a federal bailout of the states would have set the States on the road to extended federal control of states’ fiscal policies.’

7.2.3.4 Fiscal Rules and Fiscal Outcomes: An Evaluation

There are no federal constraints and no federal oversight of US state debts. Fiscal rules emerged only at state level under intense market discipline following the 1842 episode. As Sargent observes,
‘Without Congress’s 1840 refusal to bail-out the states, it is probable that those state constitutions would never have been re-written to mandate year-by-year balanced budgets.’

In 2016, 49 states had some form of BBR in place. The heterogeneity of these laws precludes full description here, but, in summary, 44 states require the governor to submit a balanced budget, 41 states require the legislature to enact a balanced budget, and 29 states are not able to carry a deficit into future years. In 35 states, at least some element of the fiscal rule is enacted into constitutional law, while 10 states are purely legislative. 40 US states also attempt to limit debt description by reference to some economic variable, such as average tax revenue (Pennsylvania), or numerical limits on general obligation debt (Arizona, North Dakota, Idaho, Iowa). As a rule, sanctions are extremely weak. In the 160-year history of fiscal rules in the US, only once has a debt law ever been the subject of judicial enforcement (and not until 2004).

A ponderous body of empirical work finds that US states comply with fiscal rules because of market discipline, not legal enforcement. A US General Accounting Office survey of budget officials in 49 states, for example, found that the primary impetus for fiscal adjustment is market discipline. By contrast, ‘Factors such as enforcement provisions, sanctions and court decisions were cited by only a few officials as being significant motivators’ Examining successful fiscal adjustments undertaken since 2009, Kelemen and Teo find that ‘The shadow of the law, the spectre of coercive history: Camden NJ (where state subsidies have ultimately ‘exacerbated, not helped, the city’s problems.’) Inman, ‘Transfers and Bailouts’ (2003), 61-65. There is also one state bailout - the District of Columbia in 1995 – but this exception ‘proves the rule’ because the District is under Federal authority that does not extend to the ‘sovereign states’: Henning and Kessler (2012), 14-15.

The exception is Vermont. Arizona and Indiana have borrowing rules in place which effectively amount to balanced budget rules. National Association of State Budget Officers, Budget Processes in the States 2015 (NASBO, 2015). For analysis of some of these rules, see: Van Malleghem (2014).

In 11 others deficits may be carried into subsequent years: California, Florida, Connecticut, Illinois, Indiana, Michigan, Nebraska, Rhode Island, Vermont, Wisconsin. NASBO (2015).


Alabama, Alaska, Arkansas, Iowa, Massachusetts, Mississippi, New Hampshire, New Mexico, Washington, Virginia.

Article IX §5 Arizona Constitution is typical: ‘The state may contract debts to supply the casual deficits or failure in revenues, or to meet expenses not otherwise provided for; but the aggregate amount of such debts … shall never exceed the sum of [350,000].’ A further 28 states fetter expenditures and revenues to an eclectic mix of variables, from oil revenues (AK) to sales tax (ND). Article 13A, §1(a) California State Constitution is typical. It limits ad valorem tax on real property to 1% of value. See: NASBO(2015), 55; Kennedy and Robbins (2001), 12.

Ten states require only an elected majority to override or amend the law. A further ten require a 2/3 majority or less. NASBO (2015). Poterba (1995), 330: ‘most states apply the balanced budget rule to only part of their budget, and there are virtually no formal provisions for enforcing state balanced budget rules.’

Kelemen and Teo (2014).


judicial enforcement of balanced budget rules that supposedly gives force was notable only in its absence. Rodden concludes, for this section:

‘This [1842] episode marked the beginning of a long period of successful market discipline among the US states… Unlike other political unions described above, the US federal government has not endeavoured to limit the deficits or debts of the US States. Yet without any hierarchical oversight or regulation, throughout the twentieth century the deficits and debt burdens of the US states have been quite low in comparison with entities in most other federations, especially considering the very large role that they play in providing basic public services and building infrastructure.’

7.2.4 Canada

Like the EMU, Canada is a large currency union whose provinces differ in terms of their economic endowments, population size, geography and language. Uniquely among the other federations in this chapter (but like the EMU), workers do not easily move between provinces, and their economic interests are often at odds: Resource-rich western provinces have little in common with industrious eastern provinces or tiny seafaring ones. Worse, Canada’s economy is inextricably entwined with the United States – the originator of the 2008 crisis. And yet, the 2008 crisis had little effect on Canada. It had no tottering debts and no imbalances to burst. Even at the height of the crisis, in 2007-2008, the provinces posted a combined $11.2bn surplus - the seventh in nine years (the federal government achieved its eleventh-straight surplus, amounting to $9.6bn). Since Canada established its ‘no bailout’ commitment in 1935, in the past 70 years no province has gone bankrupt. As Europe completes its decade of crisis, Canada’s never begun.

Canadian federalism has evolved from a relatively centralised constitution into the most decentralised federation exhibited in this chapter: [7.2.4.1] There no federal oversight or fiscal rules over the budgetary polices of the provinces; [7.2.4.2] Canada is characterised by a high degree of vertical fiscal symmetry, with near-complete provincial tax and expenditure autonomy and zero conditional transfers; and [7.2.4.4] market discipline – not fiscal rules - play a strong role in

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2336 Kelemen and Teo (2014) 365 point to the breach of California’s BBR in 2009 as expositive. In that episode, California’s credit-rating was downgraded immediately, Californian spreads rose to an unprecedented high, and California was forced to revert course and adopt a balanced budget – all before any discussion of litigation or enforcement could arise.

2337 Rodden, 'Can Market Discipline Survive?' (2014), 47.

2338 Canadian territories are excluded from this analysis, as they have a different allocation of tax and spending powers and have a different relationship with the federal government. Their position is more similar to DC in the United States, in that it is a federal jurisdiction, rather than a sovereign state. Richard Bird, Almos Tassonyi, 'Constraints on provincial and municipal borrowing in Canada: markets, rules and norms' (2001) 44 Can Public Admin 84, 85.

2339 Canadian Provinces have more trade with their neighbouring US markets than each other.


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disciplining economic policy and shaping public policy preferences. In short, Canada is the antithesis of Europe’s fiscal union. Bird and Tassonyi summarise:

‘Canada is one of the most decentralized countries in the world. Canadian provinces are responsible for most major social expenditures and have a virtually free hand in levying taxes. They face essentially no constitutional restraints on tax rates, bases or collection systems and no requirement to harmonize either with each other or with the federal government… Moreover, if provinces wish to borrow, they may borrow as and from whom they wish, with no central review or control. There are no federal controls at all over provincial borrowing, internal or external.’

7.2.4.1 Revenue and Expenditure Autonomy

The British North America Act 1867 founding the Dominion of Canada resolved all residual powers to the Dominion, and gave the Federal Parliament a power to disallow provincial statutes in certain competences. The Dominion also had near-total control over revenues: Section 91(3) empowered the federal government the power to raise money ‘by any mode or system of taxation’, and listed tariffs – around 80% of revenues at that time – as an exclusive federal competence. Finally, Section 119 of the 1867 Act provided for the payment of federal subsidies to the provinces ‘in full settlement of all future demands on Canada.’

From this inauspiciously centralised foundation, the jurisprudence of the Privy Council from 1880 to the 1920’s nonetheless ‘elevated the provinces to coordinate status with the Dominion.’ The Privy Council expanded provincial heads of power by giving priority to provincial competences, such as civil and property rights (which it interpreted broadly), and then looking to federal heads of power, such as the residuary power and trade & commerce (which it interpreted narrowly). For

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2341 ‘Canada is … one of the world’s most decentralized federations. The long-term trend has been to diminish federal control of taxing, spending and borrowing and to increase the fiscal clout of the provinces. The federal government has very few levers with which to control provincial actions… This evidence suggests that the relative fiscal independence of Canada’s subnational governments was, indeed, a boon to the Canadian economy, not a problem.’ Amy Nuget, James Pearce, Richard Simeon, ‘The Resilience of Canadian Federalism’ in Paul Peterson, Daniel Nadler (eds), The Global Debt Crisis: Haunting US and European Federalism (Brookings Institution 2014), 214, 219.

2342 Bird and Tassonyi (2001), 85-86.

2343 S. 91 Constitution Act 1867 (UK) 30 & 31 Vict, c 3 [1985] RSC App II, No 5 empowered the federal government to ‘make laws for the peace, order and good government of Canada, in relation to all matters not coming within the classes of subjects by this Act assigned exclusively to the Legislatures of the Provinces…’ S. 90 created a power of disallowance. Canada therefore lacks a residuary clause. See: Hogg (2013) 5-15.

2344 Provinces were restricted to ‘direct’ taxes and license fees. Constitution Act 1867, s92, s122. Hogg (2013) 6-1.

2345 Constitution Act 1867, s.118.

2346 Hogg (2013), 5-18. A number of political factors also conspired to decentralize Canada, including the need for political compromise with Canada’s French-speaking population, the emergence of direct taxation as a major source of revenues (a provincial power), and fiercely autonomous regions. See also: Polten and Glezl (2014), 4; Bird and Tassonyi (2003).

example, the provincial competence over ‘direct’ taxes was interpreted to include sales taxes, and the doctrine of federal ‘paramountcy’ was read narrowly and restricted to circumstances where one law necessarily violated the other. In *Hodge v the Queen (Canada)*, the Privy Council stated that provincial powers were ‘as extensive as Imperial Parliament.’ In *AG Canada v AG Ontario (Canada)*, it held that the Federal residuary power in Section 91 was not a residuary power at all, but was, in fact, a delimited federal competency like any other. The centralising powers of pre-emption had fallen into disuse by the 1930’s and are now ‘constitutional dead letters, whose use by Ottawa against either Quebec or western Canada would provoke political crisis.’ Federal and provincial tax and spending competences were famously established as ‘watertight compartments’ by the Privy Council, and this set the foundation stones for Canadian federalism.

Today, provincial governments typically spend more than the federal government, and have a larger revenue base. On the revenue side, Provinces claim over two-thirds of personal and corporate direct taxation, about 50% of VAT revenues, and 100% of resource revenues. In total, the federal share of revenues is less than half: 46.7%. Provinces are not obligated to keep the federal tax base, levy their own taxes, or match the federal tax rate. Since 1962, the federal government has offered ‘collection’ agreements to provinces, offering to collect taxes, without charge, for any province which apes the federal tax base. However, provinces may choose to administer their own tax base, in which case the federal government provides an ‘abatement’, resiling its tax rate on

2348 *Hodge v The Queen (Canada); Liquidators of Maritime Bank (Canada)*; Hogg (2013) 5-20.
2349 On paramountcy: *The Grand Trunk Railway Company of Canada v AG for the Dominion of Canada (Canada)* [1906] UKPC 72; [1907] AC 65 (UK Privy Council), per Lord Dunedin, ‘there can be a domain in which provincial and Dominion legislation may overlap, in which case neither legislation will be ultra vires, if the field is clear; and, secondly, … if the field is not clear … the Dominion must prevail.’ *Smith v The Queen* [1960] SCR 776 (Supreme Court of Canada): there must be an ‘operational incompatibility’ between the laws in order to invoke paramountcy. *Multiple Access v McCutcheon* [1982] 2 SCR 161 (Supreme Court of Canada): neither nearly identical provincial and federal insider trading legislation pre-empted as paramountcy can be invoked only when compliance with one means the breach of the other.
2350 *Hodge v The Queen (Canada)* (provincial executive powers matched their broad legislative powers).
2353 *AG Canada v AG Ontario* per Lord Atkin: ‘While the ship of state now sails on larger ventures and into foreign waters she still retains the watertight compartments which are an essential part of her original structure.’ The development of the Canadian federal state and the emergence of the Supreme Court in 1949 occurred ‘with few changes in the formal distribution of power.’ David Cameron and Richard Simeon, ‘Intergovernmental Relations in Canada: The Emergence of Collaborative Federalism’ (2002) 32 Publius 49, 50. See further: Peter Hogg, ‘Jurisdiction of the Court of the Supreme Court of Canada’ (1980) 3 Canada-US LJ 39; Hogg (2013) 6-3.
2354 The emergence of income tax in the late 19th century greatly expanded the provincial fiscal capacity, while federal tariffs decreased in significance. The first provincial income tax was introduced by British Columbia in 1874, followed by P.E.I. in 1894, with Alberta, Saskatchewan, Manitoba, Ontario, and Quebec following suit between 1923 and 1939. All provinces taxed corporations by 1903: Hogg (2013) 6-3.
2355 Courchene (1999), 308. Direct taxes, a provincial competence, make up over 47% of all collections. OECD, *Revenue Statistics 2014 - Canada* (OECD, 2014).
2357 Most provinces have accepted this deal for some form of tax or another: Quebec does not have a deal in place for personal income tax, and Quebec, Ontario and Alberta do not have a collection agreement for corporate income taxes. Cameron and Simeon (2002), 50; Hogg (1980); Hogg (2013) 6-3.
those factors to make room for the provincial taxing powers.\textsuperscript{2358} According to a long-settled convention set forth by the Government of Canada:

‘the decision of a provincial Legislature to exercise its constitutional right not to participate in any programme, even given a national consensus, should not result in a fiscal penalty being imposed on the people of the province.’\textsuperscript{2359}

On the expenditure side, there is no form of institutionalised coordination in the Canadian federation.\textsuperscript{2360} As Cameron and Simeon so put it, ‘Ottawa has neither the power nor the legitimacy to define and enforce the Canadian economic union on its own.’\textsuperscript{2361} Economic coordination in Canada is often described as ‘executive federalism’ or ‘federal-provincial diplomacy,’ in which any economic coordination is ‘a partnership between two equal, autonomous, and interdependent orders of government that jointly decide national policy.’\textsuperscript{2362}

Canada’s federal spending power plays a counter-cyclical role (estimates of regional income stabilisation range between 10-14\% of personal income or 15-20\% of GDP),\textsuperscript{2363} but even at the height of the 2009 federal stimulus (4\% of GDP), federal spending accounted for just 43\% of public expenditures, compared to 57\% by the provinces.\textsuperscript{2364} The response to the 2008 financial crisis is expositive. A federal stimulus package came mainly through cost-matching investments and direct spending in infrastructure, amounting to about $8bn in federal funds, $6bn in provincial funds, and approximately 7,000 infrastructure projects (municipal projects were usually funded at 33\% each).\textsuperscript{2365} Put simply, the provinces and the federal government ran their own stimulus programs parallel to each other, rather than through conditional transfers across competence lines.\textsuperscript{2366}

\textsuperscript{2358} Hogg (2013) 6-17.
\textsuperscript{2360} Nuget, Pearce and Simeon (2014), 207: ‘Governments report on their progress to their voters, but they were not to be accountable to Ottawa.’ The Prime Minister will often negotiate with provinces one-on-one, like separate heads of state: Bill Curry, Adrian Morrow, ‘Ontario Premier requests meeting with Harper’ The Globe and Mail (19 November 2014) <http://www.theglobeandmail.com/news/politics/article21648939/> accessed 17 June 2015. See also: Richard Simeon, Federal-Provincial Diplomacy: The Making of Recent Policy in Canada (University of Toronto Press 2006).
\textsuperscript{2361} Cameron and Simeon (2002), 56 (referring to an element of ‘confederalism’ into the Canadian federation).
\textsuperscript{2362} Cameron and Simeon (2002): ‘Governance’ generally involves the two orders of government working together as equals, it can also entail provincial and territorial governments taking the initiative on their own-acting collectively in the absence of the federal government.’ Tellier and Imbeau (2004), 3: ‘Canadian fiscal history is more one of conflict and search for accommodation than of coordination and monitoring.’. See also: Nuget, Pearce and Simeon (2014), 206-207.
\textsuperscript{2363} Métilz and Zumer (2002).
\textsuperscript{2364} OECD, Economic Surveys: Canada (OECD, 2012), 21. Provincial expenditures are composed mainly of health services (27\%), education (19\%), social services (18\%), and interest (15\%): Statistics Canada, ‘Revenues and Expenditures’ (2016).
\textsuperscript{2365} Nuget, Pearce. Simeon (2014), 217. Maximum funding was set at an equal per-capita basis:OECD, Canada (2012), 21.
\textsuperscript{2366} OECD, Canada (2012), 21-22; OECD, Canada 2010 (2010), 73. See also: Paul Hobson, Tracy Snodden, ‘Cost-Sharing and Federal-Provincial Fiscal Relations’ in Charles Beach, Bev Dahbly, Paul Hobson (eds), The 2009 Federal Budget: Challenge, Response and Retrospect (John Deutsche Institute 2010).
7.2.4.2 Vertical Fiscal Symmetry

The share of provincial revenues (56%) and federal revenues (44%) almost perfectly matches provincial (57%) and federal (43%) expenditures.2367 Furthermore, with the exception of vague (rarely enforced) standards for health care and cost-matching investments in infrastructure, conditional transfers have completely disappeared from Canadian federalism.2368

Canada has four transfer programmes, amounting to approximately 24% of the federal government’s total expenditures: the Canada Health Transfer, the Canada Social Transfer,2369 the Federal Equalisation Program, and Territorial Formula Financing.2370 The only conditions attached to any pertain to the Canada Health Transfer (CHT), a per-capita cash and tax point transfer conditional on meeting the conditions of the Canada Health Act, namely, accessibility, comprehensiveness, public administration and universality.2371 Yet these conditions are largely undefined, and leave the provinces free to design their health programmes as they see fit.2372

The federal transfer programme relevant to this thesis is the ‘Federal Equalisation Program’ which is intended to allow governments to provide reasonably comparable public services at reasonably comparable levels of taxation.2373 The system calculates entitlements by selecting a basket of provincial tax-base factors and calculating an average tax rate for those factors according to what is known as the ‘ten-province standard.’2374 The total of these calculations yields the province’s ‘fiscal capacity,’ which is then divided by its population to provide a per-capita figure. If a province has potential per capita revenues below this level, it will be entitled to a transfer to the amount of the average. Transfers are from the federal treasury and they are unconditional.

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2367 Provincial expenditures are mainly composed of health services (27%), education (19%), social services (18%), and debt service charges (15%). Statistics Canada, ‘Revenuw and expenditure’ (2016). Tellier and Imbeau (2004), 5.
2368 This is quite remarkable. In principle, there is nothing in law to prevent the ‘golden leash’ creeping into Canadian federalism: Francis Reginald Scott, 'The Constitutional Background of the Taxation Agreements' (1955) 2 McGill LJ 1 783-784. As Hogg (2013) 6-18 observes, ‘the federal Parliament may spend or lend its funds to any government or individual or institution or individual it chooses.’ However Nuget, Pearce and Simeon (2014), 209 note: conditional transfers are often seen as ‘just another opportunity for federal meddling in provincial affairs’ by provincial electorates. Cf. Those who contest the federal spending power, Andrew Petter, 'Federalism and the Myth of the Federal Spending Power' (1989) 60 Can Bar Rev 34; Sue Arrowsmith, 'Government Contracts and Public Law' (1990) 10 Legal Stud 231.
2369 The CST is an unconditional block transfer on a per-capita basis for tertiary education and other social programmes. Much like the US fiscal transfers, these transfers are funded by the federal government under a federal mandate, but implementation is left to the provinces. Provinces are accountable only to their electorates for the dollars spent. Because the amount of revenues provided is fixed without regard to expenditures, the system ‘commendably clearly puts marginal impact of expenditure and revenue decisions on provincial shoulders, thus largely obviating the problems some consider inherent with large transfer programs.’ Bird and Tassonyi (2003).
2370 Territorial formula financing is not discussed in this section, as territories have a different relationship with the federal government. See: Economic Surveys: Canada (2012), 35; Bird and Tassonyi (2003).
2371 Courchene (1999), 312.
2372 From 2014, the CHT will consist of cash transfers only, with increases capped in line with GDP growth to a minimum of 3% per year (as opposed to 6% previously). See: OECD Canada (2012), 25-26: ‘the move to a transparent, stable and ultimately less generous formula for the CHT hardens the budget constraint for provincial and territorial governments.’
2373 Section 36(2) of the Constitution Act 1982.
2374 Courchene (1999), 315.
There are two characteristics which mark this out from comparable systems in Germany and Switzerland. First, unlike Germany, it is not based on actual revenues, nor the particular expenditure needs of any particular province.2375 Entitlements are determined on the basis of potential revenue capacity, regardless of whether a Province uses a tax base factor or not. For example, Alberta does not have a VAT, but this tax base is anyways included in the calculation. Thus, Alberta does not receive equalisation payments even though other provinces have higher per-capital revenues, because it has a higher potential to tax. If any province makes more actual per capita revenues than the formula computes, it will simply get to keep both its transfer and its revenues.2376 The marginal incentive is maintained.

Second, unlike the Swiss system, ‘have’ provinces do not make transfers to ‘have not’ provinces. From the provinces’ point of view, the equalisation program is not a transfer system, but a measurement system.2377 All equalisation payments come from federal revenues and are paid out by the Consolidated Revenue Fund of Canada - ‘strictly a federal program.’2378 As these are determined on the average bases of its fellows, a province which is unable to provide an equally comparable level of public goods without defaulting on its debts will not be financed by the transfer system.2379 Nor will rich provinces be taxed for good performance, because they do not pay the transfer at all. Bird and Tassonyi explain:

‘The federal-provincial transfers system clearly puts the marginal impact of expenditure [on] provincial shoulders, thus largely obviating the problems some appear to be consider to be inherent with large transfer programs… the [connection] between local decisions on spending and local tax burdens remains largely intact at the margin for provincial governments and, since decisions are made at the margin, that is what matters.’2380

7.2.4.3 Hard Budget Constraints and Market Discipline

The choices facing the Canadian federation in the 1930’s were similar to those faced in the United States in the 1790’s and 1840’s, Germany in the 1980’s, and the European Union today. One can discern, in the early Canadian debates, recognition of the ‘flypaper effect’, soft budget constraints, and fiscal asymmetry. Most importantly, Canada learned, in 1936, the same lesson that the US

2375 For this comparison: OECD, Canada (2012), 26.
2376 Courchene (1999), 316-318 points out that Ontario received $5.8bn in transfers, but the contribution to the consolidated revenue fund amounted to $10.8bn (as taxed by the federal government), because federal taxes taxed a broader base than accounted by the formula. Unlike Germany, a province government which spends too much cannot expect an increase in transfers to balance the budget, and so provinces still have an incentive to increase revenues. Nor would an increase of revenues in, say, Nova Scotia decrease the amount it receives under the equalisation programme.
2377 This is unlike Germany, where each marginal revenue increase results in additional transfers to other states.
2378 Joe Ruggeri, Equalization Reform in Canada: Principles and Compromises (Fiscal Federalism and the Future of Canada, the Institute of Intergovernmental Relations, September 28-29, 2006), 8.
2379 Nor is it justiciable, as in Germany: Hogg (2013), 6-10: ‘The constitutional obligation to make adequate equalization payments to the poorer provinces is probably too vague, and too political, to be justiciable.’
learned in 1840 and that the EU has yet to learn: As Maxwell and MacG so put it in 1936, fiscal federalism requires provinces to be ‘allowed to go broke at their own sweet will.’

The Canadian Dominion formed in 1867 was characterised by a high degree of fiscal asymmetry. Like today’s EU Member States, Canadian Provinces were responsible for all major social, redistributive and countercyclical spending functions: unemployment insurance (until 1941), pensions (1951), ‘relief’ (welfare) payments, health, education, maternity, etc. Unlike today’s Member States, however, they also had a constrained revenue base. When the Great Depression hit, provincial debt skyrocketed as a result of spending on public welfare and, provincial revenues could not be adequately stretched to cover the obligations of the state. Provincial bonded debt and treasury bills increased by 48% between 1929-1933, from $848,501,200 to $1,255,713,300 of which 95% was directly attributable to federal ‘relief’ obligations. The Dominion responded to the crisis by, *inter alia* issuing $116,527,200 in loans to BC, Alberta, Saskatchewan and Manitoba (most of which was never repaid).

Like the 1790 assumption of US state war debts, this resulted in soft budget constraints. Under the umbrella of this bailout precedent, in 1935 the young Province of Alberta embarked on a disastrous social credit experiment which shortly bankrupted the province and pushed it to seek another bailout in March 1936. This time, following the example of 1840’s United States, the bailout was denied. Alberta defaulted on $3.2 in maturing debt on 1 April 1936 and stayed in default until 1945 (by which time it had defaulted on $33.4m in principal and $28.6m in interest). Writing at the 1936 Round Table on Public Finance, Maxwell and MacG encapsulates the lessons learned by Canada thusly:

> ‘The suggestion [has been made] that while the provincial revenues cannot be greatly expanded through the efforts of the provincial governments themselves, they can be expanded by increasing the unconditional subsidies paid by the Dominion. An advocate of this plan must neglect or brush aside all Canadian experience with these subsidies [transfers] because they have from the outset been an apple of discord in Dominion-provincial relations, they have led

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2381 Maxwell and MacG (1936), 379.
2382 Welfare was exclusively Provincial until the 1930’s, and then largely on a 1:1 matching basis with the federation. See: Bird and Tassonyi (2001), 90; Maxwell and MacG (1936).
2383 Income and commodity taxation were pre-empted by the Dominion, and the provincial tax base (mainly on gasoline, motor vehicles, corporations, inheritances and amusements) was relatively inflexible. Maxwell and MacG (1936), 381.
2384 Maxwell and MacG (1936), 381; Maxwell and MacG (1936), 377-378.
2385 Maxwell and MacG (1936), 379.
2386 E.g., one-third of Saskatchewan’s debt was written off, while the rest of the loans extended to a 30 year maturity before disappearing from public accounts in 1977. See: Bird and Tassonyi (2003); Mac Joffe, *Provincial Solvency and Federal Obligations* (Macdonald-Laurier Institute, 2012), 39-40.
2387 It had just $550,000 in its sinking fund on 1 April 1936. In March, the Provincial Auditor declared that ‘money markets were well aware that we have a very large public debt and they know that it takes a large portion of our revenue to meet the service charges on the debt that we already have.’ As cited in: Joffe, (2012), 37. See also: Carl Caldarola, *The Social Credit in Alberta 1935-1971* in Carlo Caldarola (ed), *Society and Politics in Alberta* (Methuen 1979).
to provincial extravagance, and they have intensified some of the worst aspects of Canadian political life … [causing] political friction between the Dominion and the provinces due to real or imagined infringement of provincial autonomy.  

For those inclined to listen, Maxwell and MacG may just as aptly have been writing to the authors of EU federalism today.

Today, there is no bailout expectation in Canadian federalism. Instead, Canadian federalism presents 'an extreme test of the viability of market-constrained decentralization.'  

Constitutional amendments in 1941 and 1951 dis-entangled the federal ‘relief’ obligations which had caused the 1935 crisis, and fiscal asymmetries which led to the default are now eliminated. As of 2015, the federal government has less than half of total revenues, less than half of total expenditures, and does not finance or condition any provincial competences. Although the 1930’s episode has led some scholars to argue that Canada is still an implicit ‘bailout’ federation, three other empirical findings clearly refute this. First, there is no convergence found in credit ratings, (which do not identify a bailout expectation for Canadian provinces as they do for German or EMU states). Second, credit rating agencies apply different ratings to each province, and market discipline has proven both effective and instrumental in disciplining provincial debt levels throughout the 1980’s, 1990’s, and 2000’s. Despite several recessions over these decades and no centralised fiscal constraints or coordination mechanisms, these periods are widely regarded as some

2389 Maxwell and MacG (1936), 379-382.


2391 Considering that the vast majority of federal loans ($91,614,200 - over 80%) were for expenditures which are now federal competencies, the bailouts of the early 1930’s are perhaps not surprising. This merely confirms the prediction of the literature that unfunded federal mandates lead to soft bailout constraints. Bird and Tassonyi (2003) points out that Saskatchewan’s treasury bills were purchased because its debts were incurred in service of the Dominion’s relief programme, while Alberta’s problems were owed to its failed ‘social credit’ experiment. The remaining 20% ($24,912,900) was for maturing debt: Maxwell and MacG (1936), 379.

2392 The Rowell-Sirois Commission in 1940 recommended the re-assignment of pensions and unemployment insurance to the federal level to close the vertical fiscal gap. The alternative option, of keeping these functions at provincial level and granting them greater taxing powers, was regarded as preferable but rejected on the basis that provincial revenues were not sufficiently developed. Maxwell and MacG (1936), 381-382; Kenneth Bryden, Old Age Pensions and Policy-Making in Canada (McGill-Queen's University Press 1974).

2393 Schuknecht, von Hagen and Wolswijk (2008) and Nuget, Pearce and Simeon (2014), 214 argue that while large Canadian Provinces do not operate under a bailout expectation, bond markets for small, equalisation-receiving provinces do not reflect market risks. Joffé, (2012), 12, argues that yield spreads of 30 and 23bps at the 20 and 30 year horizons are too small. This contention would seem spurious, however, since it is based on the questionable methodological assumption that narrower spreads on 30-year bonds and wider spreads on 20-year bonds indicates a bailout expectation (the opposite is true), and the author acknowledges that each province currently has remote default risk over the ten-year horizon. The report also suggests that five of Canada’s ten provinces received bailouts during the Great Depression, but not all of these provinces were even part of Canada at this time, and this contention depends on classifying federal program grants as bailouts - a criteria which would make any federation in the world a bailout federation.

2394 Provinces are also subject to a harder budget constraint than the federal government: Rodden (2006), 143.


2396 See: Courchene (1999), 331

of ‘the most successful examples of fiscal consolidation in recent history.’\textsuperscript{2398} Third, empirical evidence shows that provincial governments respond to ratings changes and are better at managing deficits - ‘largely because markets make them do so’ - than they are at managing surpluses (to which no market constraints apply).\textsuperscript{2399} Bird and Tassonyi conclude:

‘First, it appears to be widely accepted by provincial governments, and their constituents, that they are responsible for their own actions and that there will be no federal bailout. Second, as has been clear since the beginning of public-sector borrowing in Canada, credit markets clearly exert effective discipline on public-sector borrowers.’\textsuperscript{2400}

### 7.2.4.4 Fiscal Rules and Fiscal Outcomes: An Evaluation

Courchene summarises the federal arrangements for the coordination of provincial finances as follows:

‘In a word, there is no coordination! Moreover, any monitoring of provincial finances is done by the capital markets (bond-rating agencies), not by Ottawa. … Phrased differently, the provinces can tax and spend as they wish and they can borrow as long as they can find markets for their bonds.’\textsuperscript{2401}

Nine Canadian provinces and territories have, however, enacted some form of fiscal rule of their own accord.\textsuperscript{2402} Most of these laws were adopted under a period of raised market-pressure in the 1990’s.\textsuperscript{2403} Ontario,\textsuperscript{2404} British Columbia,\textsuperscript{2405} Saskatchewan,\textsuperscript{2406} and New Brunswick,\textsuperscript{2407} require the budget to be balanced \textit{ex ante}, and Alberta,\textsuperscript{2408} Manitoba,\textsuperscript{2409} Quebec,\textsuperscript{2410} and Nova Scotia,\textsuperscript{2411}

\textsuperscript{2398} Economic Surveys: Canada 2010 (2010), 69.

\textsuperscript{2399} Bird and Tassonyi (2001), 102; Landon and Smith (2000), 636.

\textsuperscript{2400} Bird and Tassonyi (2001), 91, 101.

\textsuperscript{2401} Courchene (1999), 324-325.

\textsuperscript{2402} Alberta, British Columbia, New Brunswick, Newfoundland, Saskatchewan, Manitoba, Nova Scotia, Quebec, the Northwest Territories, and the Yukon Territories. Only three have no fiscal rule in place (Ontario, Nunavut, and Prince Edward Island). Kennedy and Robbins (2001), 12; Tapp (2013), 64.


\textsuperscript{2406} Balanced Budget Act 1995 (an \textit{ex-ante} BBR with a four-year horizon). The only sanction under Saskatchewan’s law is that surpluses must be applied to a debt-reduction account. See: Tellier and Imbeau (2004) 4.

\textsuperscript{2407} Fiscal responsibility and Balanced Budget Act 2005 (\textit{ex-ante} government ‘objective’ of balanced-budget over three-year horizon to 2007, then a four-year horizon thereafter).

\textsuperscript{2408} Fiscal Responsibility Act 2000 (\textit{ex-post} BBR with contingency reserve); Balanced Budget and Debt Retirement Act 1995 (\textit{ex-post} BBR).

\textsuperscript{2409} The Balanced Budget, Debt Repayment and Taxpayer Protection Act 1995 (\textit{ex-post} BBR, with automatic carryover and sanctions in the form of salary reductions for the Executive Council; large tax changes subject to referendum).
require the budget to be balanced *ex post*. B.C. and Manitoba are the only provinces with sanctions for breach, and both legislatures recently amended their laws so that these sanctions are unlikely to bite. All of the provincial budgetary rules are exceedingly weak: The mechanisms for enforcement ‘are not well defined for any of the provinces and territories,’ and all of them are plagued by loose escape clauses ‘that would allow governments to bypass the constraints.’ The OECD notes that ‘no external/independent bodies exist’ to monitor the application of the rules, and there is little or no possibility that any of the rules could or would be enforced in the courts.

Canadian fiscal rules are, however, correlated with improved fiscal outcomes in Canada. Tapp finds that the average improvement in the budget was around 0.8% of GDP for states with balanced budget rules, and the debt-to-GDP ratio was 1% of GDP better for provinces with debt rules. Stronger fiscal rules also out-performed weaker ones.

Is the lesson to be gleaned that Canadian stability is a result of legal fiscal enforcement? Hardly. When triggered, Canadian fiscal rules are more likely to be scrapped, rather than applied. In the five provinces with the strictest debt rules, the laws were simply scrapped before sanctions could bite. In the remaining three provinces, escape clauses were invoked to avoid penalties. Tapp finds that more than 40% of Canadian fiscal rules were repealed, substantially amended, or allowed to lapse between 1981-2007, and the remaining rules crumbled in 2008, as soon as ‘the benefits of doing so were judged to exceed the political costs.’ Bird and Tassonyi conclude: ‘The more important

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2410 Balanced Budget Act 2001 (*ex-post* BBR); An Act to Reduce the debt and establish the Generations Fund 2006 (set explicit targets for gross debt (45%) and deficit (17%) as percentage of GDP).
2412 New Brunswick and Saskatchewan require the budget to be balanced over a four-year horizon, while in Quebec and Ontario, deficits must be balanced on an annual basis, allowing for primary surpluses carried forward to the next fiscal year. Manitoba also retains a rainy-day fund of up to 5% of annual expenditure, and Alberta and Nova Scotia limit the allocation of surpluses. See: Kennedy and Robbins (2001), 13.
2413 Manitoba cuts ministerial salaries by 20-40%; and BC reduces salaries by 20% if balance targets are not met. Manitoba changed its time-horizon so that the budget now has to be balanced within four years, and BC allowed for deficits until 2013. Until 2004, Ontario also had sanctions in place that reduced the salaries of the Executive Council by 25% in the first year and 50% thereafter, but this has now been abolished. See: Kennedy and Robbins (2001), 13; Tapp (2013); Tellier and Imbeau (2004). OECD, *Economic Surveys: Canada 2010* (2010), 89.
2416 Tapp (2013), 62.
2417 As predicted in Section 7.1.5, spending and revenue rules were not associated with lower debt. Tapp (2013), 53.
2418 Tapp (2013), 62 remarks, ‘separating cause from effect is always a key empirical challenge, and rule adoption is likely endogenous to the fiscal outcomes that rules target.’
2419 Ontario repealed its sanctions before the crisis, Manitoba amended their BBR to allow deficits for 4 years from 2010, BC amended its Balanced Budget and Ministerial Accountability Act in 2009 to allow for deficits until 2013, Quebec revised its timelines and Nova Scotia simply repealed their budget law: OECD *Economic Surveys: Canada* (2010), 89-90.
2420 Tapp (2013), 69.
2421 Tapp (2013), 50, concluding: ‘fiscal rules on their own cannot be relied on to improve a government’s finances.’
lesson appears to lie in the flexibility of the Canadian political system and its ability and willingness to respond to market signals.\textsuperscript{2422}

Indeed, studies parsing provincial fiscal rules and budget outcomes attribute the Canadian fiscal record to market discipline and public preference, rather than fiscal rules.\textsuperscript{2423} Tapp’s 2013 study finds that rules were adopted as part of consolidation plans (Alberta in 1992, Nova Scotia in 1993), during fiscal consolidations (Quebec in 1996) or to ‘lock-in’ completed adjustments (Manitoba in 1995, Ontario in 1999).\textsuperscript{2424} Moreover, ‘improvements also occurred in provinces that did not adopt fiscal rules (Newfoundland and PEI).\textsuperscript{2425} Miller finds good fiscal performance in all Provinces regardless of what fiscal rules are in place, and in those provinces with fiscal rules, ‘much of the progress towards deficit elimination occurred before these restrictions took effect’\textsuperscript{2426} Simpson and Wesley’s 2012 study arrives at similar results: ‘Our analysis shows that BBLs had no discernible effect in restraining expenditure growth relative to revenue growth in most provinces.’\textsuperscript{2427} Bird and Tassonyi conclude, for this section:

‘Democracy plus markets, at least in a cold climate, thus works to overcome a number of institutional features that on their face might seem conducive to flagrant fiscal misbehaviour by provincial governments. In Canada’s constitutional and political situation, budget rules, whether self-imposed (some provinces) or imposed from above (municipalities), can be effective only through the working of the same forces - and if those forces work, it is not clear that much is gained by legislating such rules.’\textsuperscript{2428}

\subsection*{7.2.5 The European Economic and Monetary Union}

Since the abrogation of the Maastricht regime, the new European Union model depends on law, rather than economics, to ‘limit the moral hazard of states turning again and again to the European union for aid.’\textsuperscript{2429} The Pringle Hypothesis is that centralised fiscal rules can ensure fiscal discipline in the presence of an established bailout precedent and institutionalised financial assistance. This is the essential economic premise upon which the emerging European fiscal union is based, and recent proposals by the Five Presidents and the European Commission endorse this premise.\textsuperscript{2430} The policy wisdom behind the emergent fiscal union implies that the unique ‘design flaw’ at the heart of the

\begin{thebibliography}{99}
\bibitem{} Bird and Tassonyi (2001), 91.
\bibitem{} Millar (1997), 8; Tapp (2013), 50, 62.
\bibitem{} Tapp (2013), 50.
\bibitem{} Tapp (2013), 50, 52.
\bibitem{} Millar (1997), 7.
\bibitem{} Simpson and Wesley (2012). ‘Our analysis suggests that, like any piece of legislation, [a balanced-budget law] is only as effective as the political will and public support surrounding it.’
\bibitem{} Bird and Tassonyi (2003).
\bibitem{} Kelemen and Teo (2012).
\end{thebibliography}
euro was the centralisation of monetary policy (a good thing) while leaving fiscal policy at national level (a bad thing). A fiscal union, so the argument goes, will rectify this error.

Theory and evidence from the EMU’s four comparators refute this hypothesis. Contrary to the misguided myth of European sui generis exceptionalism, the EMU is far from breaking new ground in combining monetary centralisation with a loose coordination of fiscal policy. The indispensable ingredients for stable fiscal relations are well-established in law, economics, and history. There are few uncharted waters and there is little room for mystery.

7.2.5.1 Soft Budget Constraints and Bailout Expectations

First and foremost, theory, history and evidence show clearly that legal sanctions cannot replace market discipline as a disciplining force. Wherever effective legal rules exist, ‘market discipline comes on top of existing institutional mechanisms.’ In so far as the EU does not conform to the condition of hard budget constraints, the ‘Pringle Hypothesis’ must be wrong. In the European Union, this would seem correct as an empirical matter: Rule-breakers are demonstrably more likely to receive a bailout (which count stands at €500.07bn dispersed over eight separate bailout agreements for five EMU Member States) than to face sanctions under EU law (which count stands at €0.00 fines levied).

The ‘Pringle Hypothesis’ has sterilised Article 125 TFEU as a matter of economics, and of law, so ‘removing a cornerstone of Europe’s model of fiscal federalism.’ In accordance with

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2431 See, e.g., European Commission, ‘Building a Strengthened Fiscal Framework in the European Union: A Guide to the Stability and Growth Pact’ (2013) European Economy Occasional Papers No 150, 5 (‘Because of the unique structure of European economic integration - specifically, a common monetary policy and decentralized fiscal policies’); Trichet, ‘Fiscal federation by exception’ (2013), 474; Bordo, Jonung and Markiewicz (2013), 450 (‘the euro is the first monetary union where monetary policy is set up at the central level, while fiscal policy is carried out at the sub-central levels. Thus, the economics profession lacks historical cases to use as guidance for theoretical and empirical work.’).


2433 In the EU, reform efforts already underway ceased when conditional financial assistance was triggered, and market discipline was exchanged for conditional finance: Boggero and Annicchino (2014), 248. See also: Zsolt Darvas, Álvaro Leandro, ‘Economic policy coordination in the euro area under the European Semester: Study provided in advance of the Economic Dialogue with the President of the Eurogroup on 10 November 2015’ (2015) PE 542680, 6.

2434 Eyraud and Gomez Sirera (2014). See also: Braun and Trein (2014), 808, concluding: ‘Whatever governance system with regard to borrowing country has developed (administrative regulation, cooperative rules, self-imposed rules or markets) opportunism will show up if there is a belief that [the central government] will be the “lender of last resort”.’

2435 This is also the operational hypothesis of this half of this chapter, and, as shown in Chapters 2 and 3, the teleology of the model inscribed in the Treaties at Maastricht. See: Hallerberg (2010), 135. Individual responsibility and fiscal autonomy was so entrenched under the text of Articles 123-125 TFEU that some economists considered Article 121 and 126 TFEU redundant: Von Hagen and Eichengreen (1995), 136.

2436 This €500.07bn figure encompasses all EU bailouts from May 2010 and December 31 2016 and excludes an additional agreed €60.75 in BoP assistance to Romania, Latvia and Hungary. Greece I: €20.1bn (IMF) + €52.9bn (BGLF). Greece II: €172.6bn (€28bn from IMF + €144.6bn from EFSF) (this included the remaining amount from Greece I, which was €110bn). Greece III: €86bn (ESM+IMF) from August 2015 to August 2018. Ireland: €68.2bn (€4.8bn bilateral + €22.5bn EFSM + €18.4bn EFSF). Portugal: €79bn (€26.5bn IMF + €24.3bn EFSM + €26bn EFSF). Spain: €43bn out of €100 ESM. Cyprus I: €2.5bn bilateral using ESM as disbursement. Cyprus II: €10bn (€1bn IMF + €9bn ESM).

2437 Wyplosz, ‘Centralization-Decentralization’ (2015), 19: ‘Although Art.125 of the TFEU strictly forbids bailouts… The EFSF, and its permanent successor, the ESM, are bailout institutions, de facto if not de jure.’ See also: Briffault (1996),
the hypothesis of this thesis, the ECB, the Commission, and the OECD now all find that markets have, in fact, been severely under-pricing economic risks in the periphery since the European bailouts, and this has, in fact, allowed those countries to increase their borrowing on bond markets.

Italy’s gross debt is now larger than Greece’s at the height of the crisis, but the interest yield on its bonds is less than AAA-rated American Treasuries. Legrain notes that, with a ‘stagnant, unreformed economy, unstable politics and public debt of 133 per cent of GDP,’ interest-rates on 10-year Italian bonds are close to 3%. So are Spain’s. Portugal, whose bonds are junk-rated, has been paying about the same or less for its long-term debt than AAA-rated Australian debt since 2014. Ireland – the fourth most indebted country in Europe - borrowed for 2.89%, less than a year after exiting its bailout programme, and is borrowing at real negative rates of -0.5% at the date of submission of this thesis. Finally, Greece - a country which the IMF has stated is insolvent - borrowed at 4.95% in one of its first bond issues. (Contrast this with AAA-rated New Zealand bonds, which are priced at 4.2%). Even during the peak of the crisis, under interest-rates which the ECB claimed were unjustified, countries in the euro still faced less pressure than countries with equivalent debt characteristics outside it.

7.2.5.2 Expenditure and Revenue Autonomy

Second, the model christened by Pringle and charted in the ‘Five Presidents Report’ creates ‘fiscal union’ by vertically co-opting Member State revenues and expenditure competences. It does not create ‘fiscal union’ by establishing its own. This is a well-known recipe for calamity with a long
pedigree.\textsuperscript{2451} The literature on fiscal federalism is clear: ‘the proper response is not a centralized solution like the SGP.’\textsuperscript{2452} Second only to the ‘no bailout’ rule, no other clearer lesson can be gleaned than that expenditure and revenue autonomy is absolutely necessary for fiscal discipline and effective fiscal rules.\textsuperscript{2453} Centralisation is not a remedy to the problems identified in Chapter 3 of this thesis - it is their cause. It is an odd result, then, that all of the EU’s nascent governance reforms regarding tax harmonisation,\textsuperscript{2454} binding macroeconomic governance,\textsuperscript{2455} binding EU-set deficit targets,\textsuperscript{2456} and binding interlinkages with Member State budgetary processes,\textsuperscript{2457} have sought to centralise power in the European Union and impair the autonomy of national governments.\textsuperscript{2458}

Wyplosz points out that the ‘Five Presidents Report’ - ‘a catalogue of proposals to establish a federal fiscal union […] does not even mention at all fiscal federalism principles.’\textsuperscript{2459} To the extent that the new fiscal rules centralise control over Member State expenditure and revenue competences, the EU is violating the oldest rules and rationales of fiscal federalism.\textsuperscript{2460}

The Commission Blueprint, for example, allow EU institutions to veto and take control of policies in national policy areas - such as by adjusting tax rates or freezing categories of fiscal spending – if the government does not implement EU recommendations.\textsuperscript{2461} There is no justification under either the FGFF or SGFF for this. What is described in these proposals is closer to a unitary state than anything presented in the literature on federalism.\textsuperscript{2462} Indeed, the notion that the federal government could veto and assume control the competences of Canadian Provinces, US States, Swiss Cantons, or even German Länder would be unfathomable in any of those legal orders. Wyplosz’ comparison of 18 countries (both unitary and federal) finds that the EU’s new governance regime ‘is both more

\textsuperscript{2451} As shown above, FGFF states that the location of fiscal capacity depends on a ‘balance’ or a ‘trade-off’ between the benefits of economies of scale (at federal level), and the distortions and pathologies this creates: Oates, 'Evolution of Fiscal Federalism' (2008); Oates, 'Towards a Second-Generation' (2005); Wyplosz, 'Centralization-Decentralization ' (2015), 7.

\textsuperscript{2452} Wyplosz, 'Centralization-Decentralization ' (2015), 11.

\textsuperscript{2453} As noted above, The constitutional reality is that fiscal rules are sometimes a political constraint, and sometimes a signal for market discipline, but never a legal constraint. Most often, they are little more than confirmatory of an already-underway impetus for fiscal consolidation:Bird and Tassonyi (2003). As Alesina (2010), 11 cautions: ‘these rules will have virtually no bite without the resolve of the government.’

\textsuperscript{2454} See: Gordon (2014).

\textsuperscript{2455} See: Chapter 8, Section 8.4.

\textsuperscript{2456} See: Chapter 8, Section 8.3.3.

\textsuperscript{2457} See: Chapter 8, Section 8.2.

\textsuperscript{2458} Noting that the EU’s fiscal rules conform to the pattern of ‘Eurolegalism’, but not the cost/benefit incentives decentralised self-accountability, Kelemen (2015), 381 observes: ‘As in other policy areas, the European Union is seeking to make up for its lack of a strong centralized administrative apparatus or large central budget by leveraging domestic courts to pursue its policy objectives.’ See also: Kelemen (2011).

\textsuperscript{2459} Wyplosz, 'Centralization-Decentralization ' (2015)

\textsuperscript{2460} Delledonne (2014), 203: The EU’s fiscal rules ‘clearly represent a corrosion of political decision-making at the national level.’ See also: Dabrowski, 'Fiscal and Macroeconomic Governance' (2015), 8; Oates, 'Fiscal Decentralization' (2006).

\textsuperscript{2461} Commission Blueprint, EMU COM(2012) 777 final; Trichet, 'Fiscal federation by exception' (2013), 479.

\textsuperscript{2462} Dabrowski, 'Fiscal and Macroeconomic Governance' (2015), 7 (and sources cited).
encompassing and intrusive than what is found in federal and unitary states. This is simply remarkable.

On the expenditure side, the centralisation of budgetary constraints eliminates Member States’ capacity to serve the imperative of macroeconomic stabilisation, without any offsetting fiscal capacity anywhere. This has ‘stripped away the shock absorbers most economies rely on’ with nothing to replace them at federal level. Henning and Kessler caution that ‘creating stringent state-level debt brakes in Europe without a capacity for countercyclical stabilisation would be a serious mistake.’ Other scholars raise the same alarm. Expenditure autonomy is a critical for a reason: As explained in Section 7.1.5.2, in a democracy, ‘the government can always choose not to abide by the “law” when it is optimal to do so.’ Wyplosz warns that restricting sub-federal expenditure and revenue competences ‘is in direct contradiction with the fact that fiscal policy is a national competence … The experience so far is that national sovereignty prevails in such instances.

For the European Union, this will ultimately mean a choice between breaking the fiscal rule or breaking the ‘no bailout’ rule. Either way, something must give: The debt rules will be broken and the Member State will provide the stimulus; or the ‘no transfer union’ rule will be broken and the EU/ECB must provide the stimulus. Indeed, this is precisely what has occurred. The minutes of the 2015th meeting of the Commission, for example, note with satisfaction that the ECB has taken on the role of fiscal stabilisation. Restricting expenditure and revenue autonomy only causes the problem it is meant to solve. Von Hagen and Eichengreen explain:

‘[T]he pressure for the central government to provide tax smoothing and automatic-stabilization services through a system of fiscal federalism will be greater where restrictions on borrowing by subcentral governments prevent the latter from providing these services themselves… if their borrowing is constrained, they will press the central government to do the

2464 Bayoumi and Eichengreen (1995)
2465 Economist, ‘The euro crisis was not a government debt crisis’ (2015).
2469 Wyplosz, ‘Centralization-Decentralization’ (2015), 18. See also: Alesina (2010), 11 (‘these rules will have virtually no bite without the resolve of the government’); Simpson and Wesley (2012), 308: fiscal rules hinge on ‘a choice between keeping legislated commitments to balance budgets or relenting to [public] pressure [to] stimulate economic activity.’
2470 Economist, ‘The euro crisis was not a government debt crisis’ (2015): observes, ‘stripp[ing] away the shock absorbers most economies rely on’ ensures that deflationary pressures will have to be combatted either by monetary expansion or fiscal transfers.’ See also: Bayoumi and Eichengreen (1995).
2471 European Commission, Minutes of the 2158th meeting of the Commission held in Brussels (Berlaymont) on 24 October 2016 PV(2016) 2158 final (2016), 22: ‘Responding to the discussion… As regards the OECD’s calls for expansionist fiscal policies, [Commissioner Dombrovskis] pointed out that this was precisely the direction being taken by the [ECB] in its monetary policy.’ Steinberg and Vermeiren (2015), find that Germany has been forced to accept monetary expansion as the price of enforced devaluation in creditor countries.
borrowing for them. For Europe this means that the EDP may spur the creation of a system of fiscal federalism in which Brussels collects taxes and provides transfers to Member States… Thus, restraints on the budgetary freedom of subcentral governments will encourage the transfer of fiscal authority to the centre and will increase the demand for central government borrowing, ultimately weakening financial stability.\textsuperscript{2472}

The days of Member State tax autonomy may also soon be numbered. Numerous studies find that the EU’s recidivistic Common Consolidated Corporate Tax Base (CCCTB) will curtail Member State revenue autonomy, creating a vertical fiscal gap reminiscent of Canadian provinces leading to the 1930’s defaults, or German Länder.\textsuperscript{2473} Gordon, for example, finds that the CCCTB ‘immobilises the tax base,’ ‘decreases GDP, raises tax rates, decreases investment [and] decreases revenue.’\textsuperscript{2474} Others reach similar findings.\textsuperscript{2475} Fabbrini’s criticism is apt: In repeatedly discounting a US federal model as being ‘too centralized and centripetal for the EU’, the Union has instead ‘ended up establishing a regime that is much less respectful of state sovereignty than the US federal system.’\textsuperscript{2476}

7.2.5.3 Vertical Fiscal Asymmetry

Third, the political economy factors behind fiscal rules and fiscal discipline are well-understood, and should not be ignored.\textsuperscript{2477} Centrally-imposed fiscal rules do not ‘work’ because they do not reflect public preferences, they undermine fiscal symmetry, and they signal the vulnerability of the centre to the fortunes of its states.\textsuperscript{2478} Feust and Peichl observe, ‘in a rather fundamental sense, fiscal governance of the Eurozone will only work if the institution which guarantees government debt also controls the policies determining government debt.’\textsuperscript{2479} For this reason, as shown in Chapter 2, the EU has had all the elements of a symmetrical ‘ideal-type’ federal fiscal union since Maastricht: Instead of providing an ex-post ‘bailout’ capacity directly to governments coping with economic shocks, the EU has had its own budget and runs its own programs independently, 99% of which comes from ‘own resources’ and 75% of which are comprised of customs duties and sugar levies – which the Member States do not share.\textsuperscript{2480} The Union’s budget is simply too small to provide the

\textsuperscript{2472} Von Hagen and Eichengreen (1995), 136.
\textsuperscript{2473} See: Section 7.2.4.3, p 223, where the revenue base of Canadian provinces could not be adequately stretched to cover increased costs of relief payments. On the restricted revenue capacity of German Länder, see: Section 7.2.1.2.
\textsuperscript{2474} Gordon (2014) 18 forebodes that ‘nothing less than the welfare of millions of people and the economic viability of entire states lie in the balance.’
\textsuperscript{2476} Fabbrini (2013), 2.
\textsuperscript{2477} For this warning: Henning and Kessler (2012), 12.
\textsuperscript{2478} Heinemann, Osterloh, Kalb (2014) 124: fiscal rules ‘reflect the underlying fiscal preferences of the voters and their political representatives.’ See also: Grinath III and Wallis (1997); John Joseph Wallis and Barry R Wieingast, ‘Dysfunctional or Optimal Institutions?’ in Elizabeth Garrett, Elizabeth Graddy, Howell Jackson (eds), Fiscal Challenges: An Interdisciplinary Approach to Budget Policy (Cambridge University 2009); Wallis (2005), 212.
\textsuperscript{2479} Feust and Peichl (2012), 8.
\textsuperscript{2480} The other two sources are VAT and one based on GNI, based on individuated national formulas, and ‘other revenue’, such as taxes on salaries of EU staff, fines, etc. Miguel Poiares Maduro, ‘A New Governance for the European Union and the Euro: Democracy and Justice’ (2013) 16 Yearb Pol Eur Stud 111. Cf, for a critique of Maduro: Craig (2014), 32-34.
side-by-side provision of public goods seen in Canada or the US, but this is probably right: All of the EU’s economic stabilisers are at Member State level, as are all of the revenues needed to finance them, and this in turn is aligned at the same level as electoral accountability.\footnote{2481} Attempting to introduce centralized transfers and legal governance into this system lacks any theoretical justification from the perspective of fiscal federalism theory.\footnote{2482} Studies applying FGFF theory to the attribution of spending competences in the EU typically find that macroeconomic stabilisation functions should not be assigned to EU level.\footnote{2483}

The nascent fiscal union plotted by the Five Presidents Report and the Commission ‘Blueprint’ - which architecture consists of conditional fiscal transfers and a ‘fiscal stabilization function’ - shows an explicit disregard for this essential principle of fiscal federalism.\footnote{2484} Here again, as Wyplosz concludes, ‘It is worrying to note that they seem unaware of the principles of fiscal federalism.’\footnote{2485} Bundesbank President Weidmann explains:

‘In order to strengthen the principle of liability at the level of sovereign states…. liability and control must be in equilibrium. In the Maastricht framework, both liability and control were, essentially, located at national level. During the crisis, however, we moved away from this: control remained national, whereas liability has been increasingly transferred to the European level. While national governments take independent decisions on debt, the community is liable for the consequences. This set-up is a breeding ground for renewed unsound developments.’\footnote{2486}

The political justification for all of the nascent elements of fiscal union – the ESM, the OMT, the Five Presidents Report and the Commission Blueprint – is the need to provide a macroeconomic stabilization capacity in the event of asymmetric shocks.\footnote{2487} The crisis, so the argument goes, proved that shock-absorbers at national level were simply too small for the weight of the imbalances created under the Euro.\footnote{2488} A larger fiscal capacity would have been better able to do the job.\footnote{2489} One must

\footnotetext{2481}{Wyplosz, 'Centralization-Decentralization ' (2015), 18.}
\footnotetext{2482}{Giandomenico Majone, 'From Regulatory State to a Democratic Default' (2014) 52 JCMS 1216, 1218: ‘the steady expansion of regulatory policy-making at the European level and the corresponding growth of the democratic deficit are possible because the costs … are borne not by the supranational regulators, but by the national regulatees … [without] such democratic controls [at] the EU level, ineffective policies can persist, unscrutinized and unchallenged, for decades.’}
\footnotetext{2483}{ECORYS, CPB and IFO, A Study on EU Spending (European Commission, 2008), 33: ‘Public choice arguments strengthen the case for centralising decisions on public spending and taxation.’ Wyplosz, 'Centralization-Decentralization ' (2015): ‘there is little scope for the centralization of any of [education, health, social security, housing, public order and safety, economic affairs and services] functions to the EU level.’ See also: Begg (2009), 27-28.}
\footnotetext{2485}{Wyplosz, 'Centralization-Decentralization ' (2015), 23.}
\footnotetext{2486}{Weidmann (2 November 2013).}
\footnotetext{2488}{Indeed, most of the deterioration of public finances during the 2008 crisis was due to automatic stabilisers - not discretionary increases in stimulus spending: Eyraud and Wu (2015), 9.}
not be misled, however. Neither OCA theory nor fiscal federalism theory require fiscal stabilisers to be placed at federal (or supranational) level.\textsuperscript{2490} What matters is that, wherever they are placed, they are symmetrical.\textsuperscript{2491} Anyways, Cottarelli and Guer Guil’s study of thirteen federations finds that ‘changes in vertical transfers in response to cyclical shocks are neither large nor common.’\textsuperscript{2492} Dabrowski points out the Euro’s history is devoid of any real examples of asymmetric shocks used to justify fiscal union.\textsuperscript{2493} The only idiosyncratic shocks in the Euro were caused by interest-rate convergence - a conclusion which Chapter 3 of this thesis bears out.\textsuperscript{2494} A central bailout capacity would do nothing to offset this problem, and much to compound it.

In order to assign the EU a stabilisation role, the fiscal capacity needed to carry out the roles assigned to it would need to amount to between 2-10% of Union GDP, encompassing ‘far-going tax schemes, social transfers, and other expenditure responsibilities.’\textsuperscript{2495} However, the tax reassignment needed to fund this ‘federal’ fiscal capacity is not only ‘politically unrealistic’ but it ‘may also be economically dysfunctional.’\textsuperscript{2496} Attempts to apply a FGFF analysis to the attribution of spending competences to the EU have typically found that macroeconomic stabilisation should not be assigned to EU level due to large distortions from centralised decision-making.\textsuperscript{2497} Under FGFF theory, ‘there is little scope for the centralization of any of [education, health, social security, housing, public order and safety, economic affairs and services] functions to the EU level, for instance.’\textsuperscript{2498}

In view of these obvious obstacles to centralising the social state, the Union is in pursuit of what Hinarejos refers to as the ‘centralisation’ or ‘surveillance’ model.\textsuperscript{2499} Under this model, Member States retain all taxing powers, and the EU enforces fiscal discipline through centralised supervision or direct control of state budgets. Since EU taxing power remains limited, countercyclical spending is financed through common-pool fiscal transfers (like the ESM) or debt mutualisation (like the

\footnotesize{2489 To this end, proponents of European fiscal union (correctly) point out that macroeconomic stabilisation is the main justification for fiscal union under both OCA Theory and FGFF theory, and the literature on fiscal federalism tends to assign fiscal stabilisation to the central level to ‘internalise’ spillovers from countercyclical spending. Trichet, ’Fiscal federation by exception’ (2013), 478. Cf: Oates, ’Essay on fiscal Federalism’ (1999).

2490 For this point: Dabrowski, ’Fiscal and Macroeconomic Governance’ (2015).

2491 Fiscal federalism and OCA theory call for countercyclical fiscal capacity to perform a macroeconomic stabilization function, but this requires an alignment between expenditure and revenue competences. See, e.g., Cottarelli (2013); Dabrowski, ’Fiscal and Macroeconomic Governance’ (2015), 11; Riekmann and Wydra (2015); Cohen (2015).


2494 Charles Wyplosz, ’The Common Currency: More complicated than it seems’ in Harald Badinger,Volker Nitsch (eds), Routledge Handbook of the Economics of European Integration (Routledge 2015) (arguing that internal imbalances in the euro constituted an asymmetric shock, so proving that the eurozone is not an optimum currency area).


2499 Hinarejos, ’Limits to Fiscal Integration’ (2014); Hinarejos, Constitutional Perspective (2015).}
EFSF or ECB) from the Member States. Proponents of European fiscal union protest that other currency unions have this.

Once again, however, one should not be misled. Calls for a US-style ‘transfer union’ and ‘mutual risk sharing’ are fundamentally misconceived. The US is not a ‘transfer union,’ and there is no mutual-risk sharing between US States, Canadian Provinces, or Swiss Cantons. On the revenue side, a recent study of thirteen federations found that federal governments ‘always finance themselves through their own taxes’ - the only exceptions being Germany in the 1870’s-1880’s and the US prior to 1790 (both of which collapsed - see Sections 7.2.3.3 and 7.2.1).

In federal monetary unions where a central capacity plays a macroeconomic stabilisation rule, this is done by increasing spending on federal programs in regions hit by adverse shocks. It is not done by establishing common-pool revenue incentives, co-opting state competences, and then providing ex-post bailouts. Contarelli and Guerguil’s study of thirteen federation finds that federal transfers in response to cyclical shocks are both small and rare - fiscal stabilisation occurs ‘as a by-product of the centralization of revenues and spending, rather than from specific, dedicated mechanisms.’ Spending mechanisms offset approximately only 15-20% of common shocks (and less for asymmetric shocks) - a number ‘roughly in line with the share of federal taxes’ in GDP. The counter-cyclical capacity is matched by corresponding revenue sources, and the lion’s share of stabilisation is left to sub-federal levels even in the most mature federations.

In sum, fiscal transfers from a central fiscal capacity are not a remedy to the problems identified in Chapter 3; they are its cause. As The Economist observes: ‘the really disconcerting thing is that the crisis response… reinforced the macroeconomic rigidity of the single-currency area.’ For this reason Dabrowski concludes that ‘such proposals will lead to building a dysfunctional fiscal union

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2500 See, e.g., Trichet, ‘Fiscal federation by exception’ (2013), 478.
2502 Cottarelli and Guerguil (2015).
2503 If a central fiscal capacity compromises fiscal symmetry and fiscal sovereignty, both FGFF and SGFF theory warns very clearly that the inherent incentives to ‘raid the fiscal commons’ will ‘undermine the performance of the public sector and perhaps the entire economy.’ Oates, ‘Evolution of Fiscal Federalism’ (2008), 319. Chalmers (2012), 692 remarks that the shifting political interests of risk-bearers, rule-breakers, competitors and customers that make up ECOFIN ‘is a very odd constellation of interests to have prime place at the table in determining what is best for a domestic economy.’
2505 Cottarelli and Guerguil (2015), 5.
2506 In Canada, for example, the provinces and the federal government ran their own stimulus programs parallel to each other, using direct spending and cost-matching expenditures, rather than conditional transfers across competence lines. See: Section 7.2.4.2. OECD, Economic Surveys: Canada (2010), 73; OECD, Economic Surveys: Canada (2012), 21-22. Similarly, the US federal government played a stabilisation role by enacting a fiscal stimulus (the American Recovery and Reinvestment Act) of $787bn by cutting federal taxes (37%, or $288bn total), spending on federal programs (45% or $357bn) and by transfers (18% or $144bn) for Medicaid ($86.9bn) and the State Fiscal Stabilization Fund ($53.6bn), which State Governors ‘may not retain any portion of the [fund] for State purposes.’ Guidance on the State Fiscal Stabilization Fund (US Department of Education, 2009), 32-33. A smaller portion (18.2%) for ‘Government Services’ was required to be used for specific public services and could not be added to the general budget or used to pay debts. See: OECD, Economic Surveys: United States (OECD, 2012), 85.
2507 The Economist, ‘The euro crisis was not a government debt crisis’ The Economist (23 November 2015)
which encourages moral hazard behaviour by both national authorities and financial markets.\textsuperscript{2508} Zeitler agrees:

‘[A]bandoning the Maastricht architecture of fiscal self-responsibility and establishing a “transfer union” … would lead to dramatic effects of moral hazard. Market participants know that there are limits to the financial capacity of even the stronger Member State. A transfer union would weaken market confidence and lead to a circuitry of events: The Euro would be exchanged at a lower rate, inflation would rise, and consequently, there would be an increase in market interest rates… All in all, this option would place the EMU itself in a position of risk.’\textsuperscript{2509}

\textbf{7.2.5.4 Fiscal Rules and Fiscal Outcomes}

Finally, as an empirical matter, it is clear that EU’s expansive fiscal governance regime is proving no more successful than its predecessors, and economists already find the new fiscal rules less credible than the 1999 SGP.\textsuperscript{2510} The EU lacks the essential institutional principles of fiscal federalism which are essential for the operation of effective debt brakes, and the EU’s fiscal rules themselves do not anyways comport with the requirements of such rules.\textsuperscript{2511} This result is, however, perhaps more intuitive than that:

‘Coordination of national economic and fiscal policies, based upon multilateral surveillance, has failed to bring about the necessary convergence of national economies. Why should more coordination with stricter surveillance do the job?’\textsuperscript{2512}

Allowing Member States a margin of error of 0.5\% of GDP, this author counts 102 breaches of the 3\% deficit limit by 23 countries between 2009-2015 (only Estonia, Luxembourg, Finland and Sweden complied),\textsuperscript{2513} and 16 countries in breach of the 60\% debt limits – only two of which (Hungary and Malta) have decreased their debt since 2009 (the rest have increased it).\textsuperscript{2514} No sanctions have ever been applied. National rules under the TSCG’s Fiscal Compact and Directive

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\textsuperscript{2508} Dabrowski, ‘Fiscal or Bailout Union’ (2013), 46.

\textsuperscript{2509} Zeitler (2014), 246.

\textsuperscript{2510} IMF, \textit{Article IV Consultation (Euro Area Policies)} (2014), 12; Eyraud and Wu (2015), 34; Smits (2015), 1162.

\textsuperscript{2511} See: Section 7.1.5. Kelemen and Teo (2012), 21 conclude, ‘the background conditions that surround these balanced budget rules actually serve to undermine the credibility of the rules.’


\textsuperscript{2513} Counting only deficits greater than -3.5\% of GDP, to allow for a 0.5\% margin of error. Eurostat, ‘Government deficit/surplus, debt and associated data’ (gov\_10dd\_3dpt1)’ (2016).

\textsuperscript{2514} Belgium, Denmark, Ireland, Greece, Spain, France, Croatia, Italy, Cyprus, Hungary, Malta, the Netherlands, Austria, Portugal, Slovenia and the UK are all in breach of the 60\% debt limit as of January 2016. Of those, only Hungary and Malta have reduced debt since 2009. Eurostat, ‘Government consolidated gross debt (gov\_10dd\_3dpt1)’ (2016).
2011/85/EU do little to change this result. In 2015, only three euro-area countries had a fiscal balance that complies with the Fiscal Compact.

The Maastricht criteria do not appear to be constraining. If anything, Blume and Voigt find that the Maastricht limits are associated with a slight increase in debt. Public debt has grown since the new governance regime, not shrunk. France, as of 2016, has now been subject to an excessive deficit procedure in twelve of its sixteen years in the euro, with no sanctions ever being applied. Both Italy and Spain, instead of reducing their deficits, are increasing them. Eyraud and Wu conclude that, despite extensive amendments ‘noncompliance has been the rule rather than the exception.’

The European Semester and the new MIP/EIP have fared little better. The MIP has been triggered several times since its enactment, with thirteen countries subject to imbalances, and eleven subject to excessive imbalances. Despite 23 countries subject to recommendations, no sanctions have ever been enforced. No EIP has ever been launched despite eleven findings of excessive imbalances, and the number of excessive imbalances has been increasing. In 2013-2014, for example the Commission identified excessive imbalances on five occasions, but did not submit a proposal to the Council to trigger the EIP. The Commission found a mere 40% response rate to recommendations in the first year of the new system - which figure had declined to 29% in 2014.

See, e.g., Kelemen (2015), 393 (‘there are few signs that the compact is working’); Gros and Alcidi (2015) (the TSCG ‘seems to have had little impact on actual fiscal policy-making’); Van Malleghem (2014), (‘Europe has not necessarily learnt the lessons from the American experience.’

Economist, 'The euro crisis was not a government debt crisis' (2015).

Tony Barber, 'The eurozone’s fiscally lax nations are at it again' Financial Times (3 November 2014). France has been in breach since 2009, after first being told to bring its deficit to the 3% ceiling by 2012: Council Recommendation of 6 April 2009 to France with a view to bringing an end to the situation of an excessive government deficit 7898/09). In February 2015, the deadline was extended to 2017: Council Recommendation of 5 March 2015 with a view to bringing an end to the excessive government deficit in France 6704/15.

Barber (2014).

Eyraud and Wu (2015), 11.

Smits (2015), 1155.

Findings of excessive imbalances include: Spain and Slovenia (2013); Italy, Croatia and Slovenia (2014); and Bulgaria, France, Croatia, Italy and Portugal (2015).

Instead, the Commission has ‘used the inherent flexibility in the [MIP] to put in motion a specific and close monitoring of policy implementation, contributing to peer pressure, real-time assessment of action and promoting reform action.’ Commission, Economic governance review COM(2014) 905 final, 8. Approximately one-third of ECOFIN statements between 1998 and 2008 were watered down in the face of non-compliance with the initial commission recommendation: Mark Hallerberg. Joshua Bridwell, 'Fiscal policy context: Co-ordination and discipline, the Stability and Growth Pact, and domestic fiscal regimes' in Kenneth Dyson (ed), The Euro at Ten: Europeanization, Power and Convergence (Oxford University Press 2008) 69. Moschella (2014), 1283 finds that this practice is widespread under the new system.

Servaas Deroose and Jörn Griesse, 'Implementing economic reforms - are EU Member States responding to European Semester recommendations?' (2014) ECFIN Economic Brief No 37. Smits (2015), 1155.
Remarkably, implementation rates under EU governance (including bailout programmes) are not better than the implementation rates of the OECD’s unilateral recommendations (which have no coordination or enforcement mechanisms whatsoever), and the rate of implementation has not increased relative to the pre-crisis (pre-amendment) period.\textsuperscript{2527} In 2014, only 10 out of 157 recommendations issued to European countries showed substantial progress.\textsuperscript{2528} Compliance with recommendations has also fallen consistently since 2011.\textsuperscript{2529} The European Parliament finds that ‘implementation of recommendations was poor at the beginning of the Semester in 2011, and has deteriorated since. … The key conclusion … is that the European Semester is not effective.’\textsuperscript{2530}

Beefed-up enforcement mechanisms do not help either: Despite much stronger legal enforcement tools in fiscal policy, the response rate for fiscal recommendations is only somewhat higher (44% on average in 2012-2014) than macroeconomic recommendations (32% in 2012-2014), a difference ‘which is not particularly high and suggests that the European Semester is not particularly effective in enforcing the EU’s fiscal rules.’\textsuperscript{2531} Comparing this to the IMF’s corrective mechanism, Moschella finds that ‘it is not obvious that the existing sanctions would actually become credible even if they were made tougher and their use simpler to activate.’\textsuperscript{2532} The ECB concludes that ‘The EU’s economic governance framework … has so far not induced sufficient implementation of national structural reforms.’\textsuperscript{2533} The IMF itself makes a similar finding.\textsuperscript{2534}

This reason for this is simple. As shown in Chapter 3, the cold reality is that it is futile to centrally-govern outcomes which are, in reality, determined by myriad private individuals responding to dysfunctional cost incentives in their economic and political lives.\textsuperscript{2535} In order to be justified under subsidiarity and proportionality, the legal justification for extending EU governance to economic policy is that the EU will, to put it simply, ‘do it better’ than Member States.\textsuperscript{2536} When weighed

\begin{footnotesize}
\begin{enumerate}
\item Darvas and Leandro (2015).
\item The Commission’s own assessments conclude that only around 10% of all CSRs were implemented in 2012-2013, despite the urgency of reform. See: Darvas and Leandro (2015), 11 (noting that overlap between recommendations is not sufficient to explain the lack of difference).
\item Darvas and Leandro (2015), finding some progress on 70 recommendations, and no or limited progress on 77 others.
\item Darvas and Leandro (2015), 5-6.
\item Darvas and Leandro (2015), 14.
\item Moschella (2014), 1283.
\item Zsolt Darvas and Álvaro Leandro, ‘The Limitations of Policy Coordination in the Euro Area under the European Semester’ (2015) 19 Bruegel Policy Contribution 1, 19: ‘This failure highlights the fundamental problem of policy coordination in the EU: national policymakers are accountable to their national parliaments and focus on national interests… we do not believe that any other method of policy coordination is likely to work much better.’ See also: IMF, \textit{Article IV Consultation (Euro Area Policies)} (2014), 12: ‘supranational controls are not sufficient to ensure fiscal discipline at the national level… credible enforcement has also to take place at the level where fiscal sovereignty is exerted.’
\item The preamble to Regulations 1174/2011 and 1175/2011, for example, state: ‘Since the objective of this Regulation, namely the … [prevention, correction and effective enforcement] of the correction of excessive macroeconomic imbalances, in the euro area, cannot be sufficiently achieved by the Member States because of the deep trade and
\end{enumerate}
\end{footnotesize}
against the lessons of FGFF and SGFF theory, this is wrong. It must be recalled that, like the MIP/EIP, Member States have long been subject to the ‘preventative’ and ‘corrective’ arms of IMF surveillance. And yet, as the IMF’s Independent Evaluation Office (IEO) concludes, ‘the IMF did not anticipate the crisis, its timing or its magnitude.’ Wyplosz concludes, ‘at no point [do] the five presidents provide any justification for this centralization step. Observing that structural reforms are needed to promote prosperity, is a far cry from justifying further centralization.’

7.3 Conclusion: The Failure of the Pringle Hypothesis as Economic Fact

The emergent model of European fiscal union supplants a legal pillar of fiscal sovereignty (an entrenched ‘no-bailout’ law) with centralised fiscal capacity and legal governance of sub-federal economic and fiscal competences. The legal justification for this surgery is the proposition referred to herein as the Pringle Hypothesis: That centralised legal governance can enforce hard budget constraints in a federated monetary union with an established bailout precedent and institutionalised financial assistance. This is the essential predicate upon which the emerging ‘fiscal union’ is based, and recent proposals by the Five Presidents and the European Commission endorse this premise.

This chapter finds that the ‘Pringle Hypothesis’ upon which the blueprint for Europe’s nascent fiscal union is based is, quite simply and profoundly, wrong. Seven centuries of history and empirical data from 106 sub-federal government units in Germany, Canada, Switzerland and the US admonish that the European Union is moving towards a formula for bad fiscal equilibrium which is well established in theory and well-evidenced in history. History cautions that centralised debt brakes never work in a decentralised fiscal federation without market discipline, and contemporary economists already find the new fiscal arrangements in the EU less credible than their financial interlinks … and the spill-over effects … and can therefore be better achieved at the level of the Union, the Union may adopt measures in accordance with the principle of subsidiarity.’

See: Chapter 3, Section 3.2.4. IMF surveillance, for example, is plagued by ‘insufficient knowledge of domestic polity, politics and policy.’ Moschella (2014), 1279. The Staff response to the 2011 IEO report complains of ‘data gaps’ between national and supranational level, in particular, lack of information about off-balance sheet exposures, risks in shadow-baking sectors, and interconnections between bank-specific balance sheet exposures.

IMF surveillance is plagued by ‘insufficient knowledge of domestic polity, politics and policy.’ Moschella (2014), 1279.

IEO, 'IMF Performance' (2011), 5. IEO, 'IMF Surveillance' (2011), 42. See also: Moschella (2014), 1277: the IMF ‘often missed the signs of impending crises’ and ‘failed to induce remedial political action from domestic authorities.’


Pringle v Ireland [136]-[137].

‘Evidence shows that fiscal responsibility laws … are not a substitute for commitment and should not be viewed as ends in themselves.’ Liu and Webb (2011).

Eyreaud and Gomez Sirera (2014): wherever effective legal rules exist, ‘market discipline comes on top of existing institutional mechanisms.’ Ter-Minassian (2007), 2 fiscal rules ‘are neither necessary nor sufficient to ensure fiscal discipline at the subnational level.’ Braun and Trein (2014), 808: ‘Whatever governance system with regard to borrowing country has developed opportunism will show up if there is a belief that [the central government] will be the “lender of last resort.”’ Foremny (2014): ‘Only deficits in unitary countries can be avoided by tying the government’s hands with fiscal rules, while they are ineffective in federations.’ See also: Kennedy and Robbins (2001); IMF, Macro Policy Lessons (2009).
predecessors.\textsuperscript{2544} Put simply, while history bears many successful examples of pure market discipline, or (fiscal rules + market discipline), there are no successful examples of fiscal rules without market discipline. As a matter of theory and evidence, the new model is an empirical failure. This is extracted from this chapter as follows:

[7.1] Centralised fiscal governance can only ever be an adjunct to a well-functioning system of fiscal federalism – it cannot replace it (and may easily ruin it). There are four essential preconditions for centralised legal governance to ‘work’ in a federal system: Hard budget constraints; market discipline; fiscal symmetry; and expenditure/ revenue autonomy. In particular, the literature ‘offers several warnings about the effective capacity of fiscal rules to constrain the action of the political branches in the budgetary domain,’\textsuperscript{2545} and such instruments ‘only create more opportunities for the types of behaviour they seek to prevent.’\textsuperscript{2546} The Pringle hypothesis, current EU proposals set out in the Five Presidents’ Report, and the Commission Blueprint do their best to violate all these conditions.\textsuperscript{2547} Dabrowski concludes:

‘Summing up, the EU and EMU have moved definitively from a ‘no bail out’ principle to conditional bail out policy with a parallel attempt to strengthen formal fiscal rules of disputable efficiency. It is worrisome that the dominant tone of the debate on the Eurozone’s fiscal union seems to go even further in this direction.’\textsuperscript{2548}

[7.2.2-7.2.4] In Canada, the US and Switzerland, state-level governments are (1) exposed to market discipline under credible ‘no bail out’ rules; (2) have complete expenditure and revenue autonomy; (3) evince a high degree of fiscal symmetry; and (4) there are no mechanisms for federal oversight of state-level budgetary policies. Despite this, when the crisis arrived in 2008, none of the 50 US States had an average deficit of more than 1% of GDP, none of the ten Canadian provinces had an average deficit of more than 2% of GDP (most had a deficit of <1%); and 24 of 26 Swiss Canton were in surplus (two had deficits of <1%).\textsuperscript{2549}

[7.2.1] The history of German federalism is a cautionary tale. Under the ‘agony of central power,’ or ‘the German problem’ of fiscal federalism, the German Federal Republic is plagued by transfer dependency and institutionalised bailout expectations that insulate Länder from market discipline and sap incentives. Despite having the strongest grade of fiscal rule embedded in constitutional law under judicial enforcement, German federalism is an empirical failure. Prior to the 2008 financial crisis, 12 of 16 Länder had deficits breaching the constitutional rule, and three were in a state of emergency. At the time of writing, Bremen, Saarland and Schleswig-Holstein remain in a state of

\textsuperscript{2544} Ter-Minassian (2007); Grooteke and Mause (2012), 280.
\textsuperscript{2545} Adams, Fabbrini and Larouche (2014), 8.
\textsuperscript{2546} ‘[The data] suggests that the EDP is redundant. In fact, our analysis suggests that the EDP is worse than redundant: it will aggravate the very problem it is designed to avert.’ von Hagen and Eichengreen (1995), 137; Briffault (1996), 177.
\textsuperscript{2548} Dabrowski, ‘Fiscal or Bailout Union’ (2013), 41.
budgetary crisis,\textsuperscript{2550} and an additional number violate sub-thresholds established by the stability council.\textsuperscript{2551}

[7.2.5] In the European Union, the ‘Pringle Hypothesis’ has institutionalised the dysfunctional market incentives of soft budget constraints identified in Chapter 3 as the \textit{causa sine qua non} of the European sovereign debt crisis, and centralised fiscal governance has, \textit{in fact}, proven institutionally non-credible and empirically ineffective. The new model has not reduced sovereign debt, even over OECD and IMF systems with no enforcement whatever; it has not improved implementation rates of EU policy recommendations; and it has not applied on its own terms. Over the course of 102 breaches of the 3% deficit limit by 23 countries between 2009-2015, the new ‘fiscal union’ has levied €0.00 in sanctions, and dispensed €500.07bn in bailouts.\textsuperscript{2552}

The literature on fiscal federalism is quite unequivocal: there is no institutional counter to myriad private individuals responding, in their economic and political lives, to dysfunctional cost incentives. So long as those incentives are broken, so also shall be the European Economic and Monetary Union.


\textsuperscript{2551} Such as the ratio of tax revenue to interest payments (Berlin), debt per capita (Berlin, Saxony-Anhalt), structural deficit per capita (Hamburg), and a limit on the percentage of debt-financed expenditures (Hesse, Rhineland-Palatine)Enderlein and Von Müller (2014), 134. This is so, according to the \textit{Beirat des Stabilitätsrats}, (15 June 2015) ‘despite very favourable effects on public finances from very low interest rates, strong bubbling sources of tax revenue and a favourable labour market situation.’

\textsuperscript{2552} This €500.07bn figure encompasses all EU bailouts from May 2010 and December 31 2016 and excludes an additional combined €43.35bn out of an agreed €60.75 in BoP assistance to Romania, Latvia and Hungary.
8. The Constitutional Boundaries of European Fiscal Sovereignty
8. The Constitutional Boundaries of European Fiscal Federalism

The preceding three analyses have found that financial assistance and centralised legal governance do not conform to the allocation of competences in the Treaty; do not conform to the substantive legal predicates of individuated fiscal responsibility; and do not conform to the substantive limits governing the boundaries of Member State fiscal sovereignty EU law. It is now mechanisms of centralised legal governance - not economic incentives - which are tasked with ensuring budgetary discipline in the European Union. The hypothesis of this thesis is that systems of fiscal federalism theory which substitute hard budget constraints for centralised legal governance are not compatible with deeper constitutional constraints of fiscal sovereignty underlying the European legal order.

In pursuance of that hypothesis, this chapter conducts a piece-by-piece deconstruction of the economic governance framework to identify instruments which directly or indirectly bind national constitutional organs in the exercise of their exclusive economic competences as a matter of law. The objective is to identify instruments of secondary EU law which have been explicitly, or ex fortiori implicitly, ruled to have been placed in legal territory subject to Member State ultra vires or constitutional identity jurisdictions, and are therefore vulnerable to abrogation by constitutional courts. For the purpose of this analysis, a legal instrument will be explicitly outside the boundaries of the Union where it has been the subject of an ultra vires or constitutional identity ruling by either the ECJ or a constitutional court. An instrument will be implicitly outside the boundaries of the Union where it violates a previously-set or acknowledged boundary of EU law by the ECJ or a constitutional court.

At the outset, it should be noted that this analysis is not concerned with ‘hard law’ sanctioning mechanisms that raise the costs of economic choices through sanctions, but are not legally binding as a matter of law. The instruments in this chapter are of concern because, as a matter of EU law, they establish requirements for what factors must be applied by budgetary decision-makers; they bind budgetary decision-makers to technical assessments issued by EU institutions; they insert EU-

2553 Fabbrini (2013), 22: Courts have begun to take on the role of ‘guardians of fiscal discipline and controllers of the budgetary policies of the political branches.’
2554 So, for example, as a matter of monetary economics and fiscal federalism theory, a failure to achieve budgetary discipline means inflation, debt mutualisation or centralized legal governance, and this offends the right to property (Article 14 BL) and the right to vote (Article 38 BL) which are part of the constitutional identity in conjunction with Article 1 BL (Human Dignity) and Article 20 BL (the Democratic State) and are not amendable under Article 79(3) BL, lex lata or lex ferenda: Brunner (Germany) [56].
2555 The OMT program is an example of an instrument for which this has occurred: Gauweiler I (Germany); Gauweiler III (Germany).
2556 The EFSM and EFSF are examples of instruments for which this has occurred. The EFSM (as acknowledged by the CJEU and the European Council), the EFSF (as acknowledged by the CJEU) and ESM (owing to rulings by the German, Irish and Estonian constitutional courts), and the OMT (owing to a ruling by the German Constitutional Court) have all either been ruled as violating EU law or implicitly held to do so by the CJEU or a national court.
2557 It is important to distinguish this from sanctions under the SGP, which are a form of ‘hard law’, but are not legally binding. Sanctions raise their own issues of legitimacy under the community method, but they are distinct from legislation which binds national decision-makers in their budgetary powers at national level, which is the subject of this thesis.
law objectives, policies and rules into national budgetary processes; or they establish legal obligations for the content of Member State budgets themselves. Binding legal force will be defined here as obligations which acquire the force of supremacy of EU law, are capable of giving rise to infringement proceedings under Articles 258-260 TFEU, and are thus capable of supplanting Member State economic policy by legal decree (not merely financial penalty). In all cases, the criteria for identifying such an act is simple: the failure to take the legislated-for economic policy decision will, in principle, lead to a breach of (directly applicable and supreme) EU law.

The analysis finds that fully seven out of the eight legal mechanisms necessary for the functioning of the new model examined in this chapter violate an explicit ruling or constitutional test set for what is a permissible constitutional state in the realm of fiscal sovereignty. Each of the four pillars upon which the new ‘fiscal union’ depends contains at least one such mechanism. The conflicts identified in this section occur along two boundaries between EU and national legal orders.2558

First, when measured against the horizontal allocation of legislative competences, economic governance under the European Semester, the MSP, EDP and the MIP/EIP no longer bears any resemblance to the legislative competences of the Union. EU fiscal governance has entered exclusive national economic and social policy domains both through the expansion of existing fields and integration with new, economic ones.2559 Bekker notes, for example, that Europe 2020 ‘integrates the economic, social and employment policy fields, whereas these policy areas fall Treaty-wise within the scope of different coordination methods granting different competences to the EU.’2560 Under the SGP, the operationalisation of the MTO has expanded budgetary surveillance from the simple tabulation of 3% and 60% numerical debt limits, to line-by-line analyses of the whole panoply of economic, social and welfare decisions which constitute that balance.2561 The introduction of the MIP/EIP has brought virtually all aspects of national economic, social and fiscal policy within reach of the ‘hard law’ disciplines of fiscal governance, such that the lines are increasingly blurred between the task of tabulating budgetary sums and fine-tuning the national economy. Sanction-backed country-specific recommendations do not distinguish between policies in which the EU has some competence, such as the internal market, and those which would clearly be ultra vires at EU level (like direct taxation).2562 Nor do they distinguish between those aimed at the fiscal balance and those which exclusively concern the internal organisation of the social state (such as the location of social housing in the Netherlands).2563 In-depth reviews established under the MIP, for example, often yield

2559 Bekker (2013), 3
2560 Bekker (2013), 3
2561 Rec 28. Reg 473/2014, for instance, states that ‘budgetary measures might be insufficient to ensure a lasting correction of the excessive deficit’ and requires a far-reaching EPP encompassing social and welfare policy.
2562 See: Section 8.4.2.
policy recommendations which are justified by the imperative of reducing the deficit (and vice-versa).  

This implies that ‘the EU could potentially be entering domains of national sovereignty via the backdoor of economic governance,’ and may be challenged under national ultra vires jurisdictions. Lindsøth explains:

‘This is a genuine concern: no delegation of authority, on a ‘precommitment’ basis or otherwise, can be of such an indeterminate scope as to constitute an abdication of the democratic character of national institutions … a point echoed by numerous national high courts in their European jurisprudence of the last two decades. As the Danish Supreme Court (the Højesteret) put it in 1998, the really difficult challenge is determining whether and how supranational delegation might imperil “the constitutional assumption of a democratic system of government” on the national level.’

Second, when measured by their vertical enforcement mechanisms, many of these instruments appear to conflict with specific tests laid out for democratic legitimation under Member State ‘constitutional identity’ jurisdictions. In Re ESM (Germany), for example, the BVerfGE held that the TSCG could only be lawful if it ‘does not grant the European commission authority to impose specific substantive requirements for the structuring of budgets.’ Yet this is the explicit objective of several EU law instruments enacted since that decision – including the ‘two pack’, which does insert a Commission authority to ‘impose the structuring of budgets’ into the TSCG. This appears to violate three such rulings on the TSCG (See Section 8.2.2). Similarly, the explicit aim of the ‘six pack’ and ‘two pack’ is to ‘ensure the integration of EU policy recommendations in the national budgetary preparation’ (see Section 8.3.3). Norms produced under the EU’s ‘coordination’ competence no longer resemble the ‘soft law’ coordination framework of the OMC. Instead, the new framework ‘in many ways entails a return to “command and control” regulation’ that stretches beyond existing models of democratic accountability under either the ‘community method’ or the ‘intergovernmental method.’ Scholars sifting through the framework repeatedly find structures which appear ‘remarkably a-legal,’ or which fall into a ‘grey zone’ between national and EU

2564 See, e.g., Council Recommendation of 14 July 2015 on the SCP of the UK
2565 Bekker (2013), 3
2567 The BVerfGE, for example, has stated that the legislature must ‘make its decisions on revenue and expenditure independent of Union institutions and of other Member States’, and that an intrusion into ‘fundamental fiscal decisions on public revenue and public expenditure [and] decisions on the shaping of the social state’ would violate the constitutional identity of Germany. Re ESM II (Germany) [164].
2568 Re ESM II (Germany) [244].
2569 See, in particular, Arts 3, 4(1) and 6(1) Reg 473/201.
2571 See: Chalmers (2012), 683; Chiti and Teixeira (2013); Pernice (2014); Costamanga (2014).
2572 Chalmers (2012), 682.
law. As Menéndez remarks, ‘all these changes imply a clear break from the Maastricht ‘model’ … it is hard to keep on affirming that Member State retain the power to conduct their fiscal policy autonomously.’

Yet while scholars remark that EU measures appear to fall into ‘gaps’ between systems of democratic and legal accountability, there are no ‘gaps’ between constitutional orders. Since the EU legal order is bound by the principle of conferral, each boundary of the Union’s competences is, principle, a border with national constitutional law. In the realm of economic policy, this means fiscal sovereignty – the core of constitutional identity. The ongoing viability of the new model is now contingent on the constitutionality of its constituent mechanisms. As Pernice so puts it:

‘National constitutional courts … establish constitutional constraints not only on the discretionary powers of their respective governments participating in the coordination mechanisms, but also on the terms of a possible revision of the EU treaties aiming at adapting them to the challenges ahead… the answer to the question “what is solution to the crisis?” has to take account of the limits of European integration in terms of national constitutional law.’

[8.1] This chapter begins with an overview of the European governance procedures as they operate at EU level. It then proceeds through four separate analyses, each deconstructing one of the constituent pillars of the new model to identify binding interlinkages which Member State legal orders. It examines:

[8.2] Binding vertical interlinkages with Member State budgetary frameworks;

[8.3] Binding vertical interlinkages with EU fiscal governance;

[8.4] Binding vertical interlinkages with EU macroeconomic governance; and

[8.5] Binding vertical interlinkages with EU conditional financial assistance.

In total, it identifies eight separate legal machineries under these four pillars, seven of which violate one of the tests for constitutional identity in this thesis. All four pillars are dependent on the good functioning of at least one mechanism that is *prima facie* incompatible with the European legal order.

### 8.1 Overview of Economic and Fiscal Governance Procedures at EU Level

Before the analysis can begin, it is necessary to set out the totality of the economic and fiscal governance procedures as they are intended to operate together as a single contiguous governance system. The economic governance architecture consists of five procedures: The European Semester;

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2573 Mark Dawson, 'The Legal and Political Accountability Structure of 'Post-Crisis' EU Economic Governance' (2015) 53 JCMS 976, 984, referring to a ‘grey zone’: ‘Post-crisis governance departs from the mechanisms of legal and political accountability present in previous forms of EU decision-making without substituting new models of accountability in their place.’ See also: De Streefl (2014), 101 (examining ‘legitimacy gaps’); Menéndez (2014), 129; Costamanga (2014).
2574 Menéndez (2014), 129.
2575 Pernice (2014), 298, 303.
the Multilateral Surveillance Procedure (MSP) and Excessive Deficit Procedure (EDP); the Macroeconomic Imbalance Procedure and Excessive Imbalance Procedure (MIP/EIP); and financial conditionality under the ESM. Throughout these procedures, EU institutions generate policy outputs (in the form of recommendations, decisions or opinions) that are established, incorporated or enforced through a constellation of secondary EU legislation (in the form of regulations and directives) under the ‘six pack,’ ‘two pack’ and the ‘Stability and Growth Pact.’ Each of these procedures are designed to enshrine and enforce a core obligation for Member States at EU level.

[8.2] The first is the European Semester for economic policy coordination. Established under the ‘six pack’ and fortified with respect to Euro Member States by the ‘two pack’ legislation, the European Semester is an annual surveillance coordination cycle that fully integrates the MSP, the MIP/EIP, and the EDP with Member State budgetary frameworks (as amended under Directive 2011/85/EU and Reg 479/2009) under a single integrated timeline. The central obligation under the European Semester is for Member States ‘take due account of the guidance addressed to them in the development of their economic, employment and budgetary policies before taking key decisions on their national budgets for the succeeding years.’

[8.3] The second is the Multilateral Surveillance Procedure (MSP). The central obligation under the MSP is to comply with the country-specific Medium-Term Objective (MTO). Under the amended MSP, the MTO is a 3-year target for the structural deficit set within a prescribed range of -1% of GDP and balance or surplus. For Member States which have not reached their MTO, the obligation to adhere to the MTO becomes an obligation to adhere to the adjustment path towards the MTO, defined as a reduction in the cyclically-adjusted structural deficit of 0.5% of GDP at a benchmark per annum. Member States with gross debt of over 60% of GDP or pronounced sustainability risks must achieve an annual improvement of the cyclically-adjusted budget balance, adjusting for one-off and temporary measures, greater than 0.5% of GDP. If the Member State is within three years of an EDP, the adjustment path will be the cyclically-adjusted minimum linear structural adjustment (MLSA) necessary to ensure compliance with the debt brake by the end of the

2576 The European Semester is set out under Art 2-a Reg 1466/97 as amended by Art 1 Reg 1175/2011, and is supplemented by Reg 473/2013 for Euro Area Member States. Member States must now implement a Common Budgetary Timeline into their national budgets to coincide with the European Semester. Member States must (i) adopt a national medium-term fiscal plan by 30th April; (ii) adopt a draft budget for the forthcoming year by 15th October; and (iii) adopt the budget by 31 December each year. Art 4 Reg 473/2013.


2579 It should be noted that the TSCG further constricts this rule to a prescribed MTO of better than -0.5% of GDP for its signatories, excepting where the debt-to-GDP ratio is significantly below the 60% threshold and risks to long-term sustainability are low. In that case the lower limit is once again 1% of GDP. See: Arts 3(1b) and (1d) TSCG.


three-year transition period. In order to support the MTO, Member States must also now comply with an expenditure benchmark linked to potential GDP growth.

[8.3] The third is the Excessive Deficit Procedure (EDP), or the ‘corrective’ arm of the SGP (Article 126 TFEU). Under the EDP, the general government debt balance must comply with two variables. First, they must comply with the 3% of GDP deficit limit in Article 126(2)(a) TFEU, unless either: (i) the ratio has declined substantially and continuously and reached a level that comes close to 3%; or (ii) alternatively, the excess over 3% is ‘exceptional and temporary’ and the ratio remains ‘close’ to 3%. Second, they must comply with the 60% of GDP debt limit unless the ratio is ‘sufficiently diminishing’ and approaching 60% at a satisfactory pace.

[8.4] The fourth is the MIP/EIP. The core duty under the MIP/EIP is to correct ‘macroeconomic imbalances’ and ‘excessive imbalances.’ Imbalances are ‘any trend giving rise to macroeconomic developments which are adversely affecting, or have the potential adversely to affect, the proper functioning of the economy of a Member State or of the [EMU] or of the Union as a whole.’ Excessive imbalances are ‘severe imbalances, including imbalances that jeopardise or risks jeopardising the proper functioning of the economic and monetary union.’

[8.5] The fifth is the conditional financial assistance procedures of the ESM. The core duty under those provisions is to comply with macroeconomic adjustment programmes that in turn must be ‘fully consistent with’ the substantive policy outputs of EU institutions.

Compliance with these core duties is enforced at EU level through the successive ratcheting procedures of the European Semester, MSP, the EDP and the MIP. Each stage of these procedures is

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2583 For Member States which have achieved their MTO, annual expenditure growth should not exceed a reference medium-rate of potential GDP growth, unless matched by discretionary revenue measures: Arts 5(1)(a), 9(1)(a) Reg 1466/97 (as amended). For Member States which have not, expenditure growth must be set below the medium-term rate of potential GDP growth, to ensure an appropriate adjustment towards the MTO: Arts 5(1)(b), 9(1)(b) Reg 1466/97 (as amended). Expenditure excludes interest expenditures, expenditures on Union programmes, and non-discretionary changes in unemployment benefit expenditure. Discretionary reductions in revenue must also be linked to reductions in expenditure.
2584 Art 1, Protocol (no 12) on the excessive deficit procedure; Art 2(2) Reg 1467/97 (as amended): An excessive deficit may be considered ‘exceptional’ where an unusual event ‘outside the control of the Member State concerned’ results in negative annual GDP volume growth an accumulated loss of output during a protracted period of very low GDP growth relative to potential. See also: Arts 3(1)(c),(d) TSCG.
2585 A satisfactory pace is defined as a reduction of the differential between the actual debt level and the 60% reference value of an average rate of 1/20th per annum: Art 2(1a) Reg 1467/97 (as amended). An excessive deficit will be ‘sufficiently diminishing’ if it meets an annual improvement in the cyclically-adjusted budget balance of at least 0.5% of GDP. If the Member State is in breach of the 60% threshold and has exited an EDP within the past three years, the Member State will be required to adhere to the MLSA to ensure compliance with the debt brake by the end of the three-year transition period. The Member State concerned must not deviate from the adjustment path by more than 0.25% of GDP. See: European Commission, ‘Specifications of the Council of 3 September 2012 on the SGP’ (2012), 9. See also: Art 4 TSCG.
2588 Art 7 Reg 472/2013.
accompanied by the issuance of detailed, sanction-backed economic policy recommendations adopted by the Commission or Council under Articles 121(2), 121(4), 126(3), and 126(5)-(9) TFEU.

8.1.1 Stage 1: The European Semester

The European Semester commits Member States to a single budgetary timeline with four main interlinkages with Member State budgetary processes. First, the European Semester begins in January with the adoption of the Annual Growth Survey (AGS) (which outlines broad economic guidelines for the EU as a whole);\(^{2589}\) a draft recommendation for the Euro Area;\(^ {2590}\) and the Alert Mechanism Report (AMR) which evaluates economic ‘imbalances’ against a ‘macroeconomic scoreboard’ of 14 variables.\(^ {2591}\)

Second, by 20 April each year, Member States are required to submit annual Stability and Convergence Programmes (SCPs) which set out their planned medium-term budgetary policies;\(^ {2592}\) as well as a new National Reform Programme (NRP) concerning structural reforms. SCPs – initially aimed at the government balance – now present information on a broader set of variables, including the planned growth path of expenditure and revenues,\(^ {2593}\) ageing and other contingent liabilities,\(^ {2594}\) as well as consistency with the AGS and the NRP,\(^ {2595}\) and information on the progress of EU-

\(^{2589}\) The AGS outlines the general economic guidelines for the EU as a whole based on Europe 2020, a new growth strategy to replace the failed Lisbon Agenda, based around five headline targets: Raising employment among 20-64 yr olds from 69% to 75%; annual investment in R&D of 3% of GDP; reduction in greenhouse gas emissions by 20-30% (compared to 1999) and increase the share of renewables to 20%; reduce early school leavers to 10% from 15% and increase the share of 30-34 year olds with tertiary education to 40% from 31%; and reduce the number of Europeans living below poverty lines by 25%. The AGS is Provided for by Art 2-a(2)(a) Reg 1466/97 under Art 121(2) TFEU and is accompanied by a Joint Employment Report under Art 2-1(2)(b) Reg 1466/97 (Art 148 TFEU). See: Commission, ‘Europe 2020’ COM(2010) 2020 final; European Commission, ‘The EU’s economic governance explained’ (2014). For analysis, see: Kenneth A Armstrong, 'The Lisbon Strategy and Europe 2020: From the Governance of Coordination to the Coordination of Governance' in Dimitris Papadimitriou , Paul Copeland (eds), The EU’s Lisbon Strategy (Palgrave Macmillan 2012) 208.

\(^{2590}\) The AGS and AMR are issued prior to the start of the budgetary year, in November. From 2016, the draft recommendations for the Euro Area are published at the same time, for adoption in March. See: European Commission, Report on the Euro Area SWD(2015) 799 final; European Council Conclusions of 18-19 February (2016) EUCO 1/16, 7.

\(^{2591}\) These are prepared under the Union’s ‘coordination’ competence to recommend broad economic guidelines (Articles 2(3), 5 and 121(2) TFEU), in conjunction with Article 136 (for the euro recommendations). As such, they are not legislative instruments and are not addressed to specific Member States. There are also no sanctioning mechanisms or EU institutional body responsible for their implementation. For discussion, see: European Parliament, Briefing: Euro area recommendations under the 2016 European Semester [2016] PE542.682; Commission, Report on the Euro Area SWD(2015) 799 final. The scoreboard is established by Arts 3, 4 Reg 1176/2011, under Art 121(2) TFEU. The 14 headline variables are supplemented by and 25 auxiliary indicators. See: Section 8.4.1. See also: European Commission, 'Scoreboard for the surveillance of macroeconomic imbalances' (2012) European Economy Occasional Papers No 92; European Commission, 'Completing the Scoreboard for the MIP: Financial Sector Indicator' SWD(2012) 389 final; Commission, ‘Financial Sector Indicator 2011’ SWD(2012) 389 final; European Parliament resolution of 15 December 2011 on the Scoreboard for the surveillance of macroeconomic imbalances: envisaged initial design (P7_TA(2011)0583).

\(^{2592}\) The programmes are intended to encompass both the preceding year and a horizon of three years: Arts 3(3), 7(3) Reg 1466/97 (as amended). Under Arts 3(2a), 7(2a) Reg 1466/97 (as amended) medium-term fiscal plans must be based on the most likely macrofiscal scenario, compared against the Commission’s Country Reports under a ‘comply or explain’ rule.

\(^{2593}\) Arts 3(2)(a), 7(2)(a) Reg 1466/97 (as amended).

\(^{2594}\) Arts 3(2)(ab), 7(2)(ab) Reg 1466/97 (as amended).

\(^{2595}\) Arts 3(2)(b), 7(2)(b) Reg 1466/97 (as amended).
recommended policies in national legislative processes. The introduction of NRPs means that, together, these programmes now encompass a virtually-unbridled litany of economic policies not previously subject to centralised surveillance, such as the healthcare sector, housing, climate change, education and poverty.

Third, in July the Council issues country-specific recommendations (CSRs) for each Member State regarding the substantive content of its SCPs and NRPs. Article 2-a(3) of Reg 1466/97 then introduces a new duty which states that Member States ‘shall take due account’ of the guidance addressed to them ‘before taking key decisions on their national budgets for the succeeding years’ (previously, the only duties to ‘take due account’ under the SGP applied to the Union’s discretion). At EU level, a failure to ‘act upon the guidance received’ will be subject to (a) more specific recommendations; (b) a warning under Article 121(4) TFEU; and (c) sanctions under the MSP, EDP or MIP - each of which comes attendant with its own interlinkages with national law discussed in subsequent sections of this chapter.

Fourth, under Article 6(1) of Reg 473/2013, Euro Member States must then submit their draft budgets for inspection by 15 October, in response to which the Commission will issue an Opinion by 30 November. If approved, Member States will adopt the draft budget by 31 December, concluding the annual European Semester. If the Commission finds that the proposed budget is in ‘particularly serious non-compliance,’ it will request that the budget be redrafted.

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2596 Including whether the national parliament has been given opportunity to discuss any EU recommendations, warnings or opinions on national programmes: Art 3(4), 7(4) Reg 1466/97 (as amended).
2597 SCPs, NRPs and medium-term fiscal plans may all be the same document: Arts 2-a(2)(d), 4, 5 Reg 1466/97 (as amended); Art 4(1) Reg 473/2013.
2598 These are proposed by the Commission in May, and then endorsed by the Council in July: Art 5(2) Reg 1466/97.
2599 Art 2-a(3) Reg 1466/97 (as amended by Art 1(3) Reg 1173/2011). Cf: rec (6) of Council Regulation (EC) No 1056/05 on the excessive deficit procedure [2005] OJ L 174/5 (‘due account should be taken of the economic heterogeneity in the European Union’). The duty to ‘take due account’ is not examined here because, expression unis est exclusion alteriae, EU legislation prescribes sanctions for rule-breakers. However, there is an abundant case law establishing that an EU law obligation to ‘take due account’ is capable of binding decision-makers, such that legislation which precludes consideration of those factors must be set aside for inconsistency. See: Case C-427/12 Commission v Parliament (Grand Chamber, 18 March 2014) [49] (duty to take ‘due account’ of deadlines specified in EU legislation constituted a duty to stick to those deadlines); Case C-558/14 Khachab (Fourth Chamber, 21 April 2016) [70]-[71] (obligation to take ‘due account’ of listed factors 5 requires specific consideration of each factor); Case C-226/11 Expedia Inc v Autorité de la concurrence and Others (Opinion of AG Kokott, 6 September 2012) [38] (duty to ‘take due account’ does not permit Member States to ignore a competition policy notice issued by the Commission); Case C-57/15 United Video Properties (Fifth Chamber, 28 July 2016) at [23]-[27] (an obligation to take ‘due account’ of the specific characteristics of each case when calculating legal costs is not met where legal costs are calculated at a flat rate below the average cost of services for a lawyer); Case C-481/14 Hansson v Jungpflanzen Grünewald GmbH (Fifth Chamber, 9 June 2016) [37]-[40] (obligation to take ‘due account’ of specific characteristics of each case not met where damages assessed on a basic flat rate infringer supplement); Case C-562/13 Centre public d’action sociale v Abdida (Grand Chamber, 18 December 2014) [53], [58] (duty to take due account of the health of individual in Art 5 of Directive 2008/115 precludes legislation which does not allow suspending decisions which may pose a risk to health).
2601 Art 7 Reg 473/2013.
2602 Art 4(2) Reg 473/2013.
2603 Art 7(2) Reg 473/2014.
Importantly, each stage of this budgetary timeline is bound by Articles 3, 4(1) and 6(1) of Reg 473/2013, which state that Member State ‘budgetary procedures,’ ‘medium-term budgetary plans,’ and draft budgets themselves ‘shall be consistent with’ inter alia, CSRs under Article 121(2) TFEU; any and all recommendations issued under Regulations 1466/97, 1467/97, 1176/2011, and 473/2013; and the Opinion on the EPP under Article 9 of Reg 473/2013.2604

8.1.2 Stage 2: Activation of Macroeconomic and Fiscal Governance Procedures

Once activated, the MSP, the EDP, MIP and EIP each become a separate offshoot of the European Semester, but all follow a similar procedure. Each begins when the Commission makes a finding of ‘significant observed deviation’ from the MTO (MSP),2605 an ‘excessive deficit’ (EDP),2606 a macroeconomic imbalance (MIP),2607 or an excessive imbalance (EIP)2608 and then makes a recommendation to that effect.2609 On the basis of the Commission recommendation, the Council will then take a decision establishing the significant observed deviation,2610 excessive deficit,2611 macroeconomic imbalance,2612 or excessive imbalance,2613 accompanied by a recommendation specifying the specific policy measures necessary to bring the situation to an end. Under Articles 121 and 126 TFEU, each of these decisions is taken by QMV in the Council.2614 However, under Article 7 of the TSCG, formed outside the Treaties by intergovernmental method, EMU Member States are committed to supporting the Commission’s proposals under the EDP unless a QMV object. This means that, in practice, the decision to initiate an EDP against any Euro Area Member is taken by RQMV. The effect of RQMV in this area is examined in Section 8.3.4.2615

As a final note, it is important to remark that all Council decisions to adopt Commission recommendations under the SGP are taken under a ‘comply or explain’ rule.2616 Reg 1467/97 states

2604 See: Section 8.2.2 Arts 3, 4(1) 6(1) Reg 473/2013.
2605 Article 6(2), 10(2) Reg 1466/97. In the event of a ‘significant observed deviation’, the Commission will also issue an autonomous warning to the Member State under Article 121(4) TFEU.
2606 Article 126(5) TFEU; Article 3(1)-(2) Reg 1467/97.
2607 Article 121(2) TFEU; Article 6(1) Reg 1176/2011.
2608 Article 121(4) TFEU; Article 7(1) Reg 1176/2011.
2609 MSP: Article 121(4) TFEU; Article 6(2), 10(2) Reg 1466/97. EDP: Article 126(6) TFEU; Article 3(3) Reg 1467/97. MIP: Article 121(2) TFEU; Article 6(1) Reg 1176/2011. EIP: Article 121(4) TFEU; Article 7(2) Reg 1176/2011.
2610 MSP: Article 121(4) TFEU; Article 6(2), 10(2) Reg 1466/97.
2611 EDP: Article 126(6) TFEU; Article 3(3) Reg 1467/97.
2612 MIP: Article 121(2) TFEU; Article 6(1) Reg 1176/2011.
2613 EIP: Article 121(4) TFEU; Article 7(2) Reg 1176/2011.
2614 MSP: Article 121(4) TFEU; Arts 6(2), 10(2) Reg 1466/97 (setting a deadline of 3-5 months). EDP: Article 126(7) TFEU; Article 3(3)-(4) Reg 1467/97 (setting a deadline of 3-6 months). MIP: Art121(2) TFEU; Article 6(1) Reg 1176/2011 (no deadline required). EIP: Article 121(4) TFEU; Article 7(2) Reg 1176/2011 (no set deadline).
2615 For comment, see: Chalmers (2012), 688; De Streel (2014), 93; Wim Van Aken, Lionel Artige, ‘A Comparative Analysis of Reverse Majority Voting’ in Bruno De Witte, Adrienne Herritier, Alexander Treschel (eds), The Euro Crisis and the state of European Democracy (EURO Dissemination Conference, European University Institute 2013) 129.
2616 Art 2-a(3) Reg 1466/97 (as amended) states that, on the basis of Commission recommendations, the Council ‘shall, as a rule’ address guidance to the Member States, ‘making full use’ of the legal instruments available,
that the Council is ‘expected to, as a rule, follow the recommendations and proposals of the Commission or explain its position publicly.’

8.1.3 Stage 3: Correction

The breadth and intensity of the governance regime varies at this stage depending on which procedure the recommendations fall under and whether it applies to an EMU Member State or not. Both of the ‘preventative arms’ - the MSP and MIP - require that the Member State report on action taken in response to the recommendation by the deadline. Stronger specific surveillance and sanctions apply under the MSP, EDP and EIP.

Under the EDP, the Member State must report to the Council and the Commission on the action taken in response to the recommendation. If the Member State in question is an EMU country, it must also submit a far-reaching Economic Partnership Programme (EPP) encompassing extensive reporting requirements on planned policy measures and structural reforms. The EPP must ‘identify and select a number of specific priorities’ which ‘fully take into account the Council recommendations on the implementation of the integrated guidelines.’ If the plan is insufficient, it will be asked to re-submit the action plan. If it does not, it will be found in ‘non-compliance’ and sanctioned where the it fails to take the corrective action recommended by the Council.

Under the EIP, the Member State must submit a far-reaching ‘Corrective Action Plan’ (CAP) based on, and within a deadline to be defined in, the recommendation establishing an excessive imbalance Article 121(4) TFEU. This consists of the specific policy actions the Member State intends to implement to enhance competitiveness and structural weaknesses, and encompasses virtually any aspect of economic, social and welfare policy. The CAP will subsume the EPP if both exist. If the plan is not sufficient, the Commission will recommend that the Council request a new corrective action plan be drafted within 2 months as a rule. Once again, the Member State will be found in

2617 Arts 2-a(3); 2-ab(2) Reg 1466/97; Art 2a Reg 1467/96 (as amended).
2618 MSP: Arts 6(2), 10(2) Reg 1466/97. MIP: Article 2-a(d) Reg 1466/97. For the MIP, this will typically take the form of the NRP required in the ordinary course of the European Semester.
2619 Art 3(4a) Reg 1467/97 (for all Member States).
2620 Corrective action must be taken within six months (three months in serious situations), and the deficit must be corrected within a year unless there are special circumstances: Arts 3(3),(4) Reg 1467/97. The EPP is provided for under: Article 9 Reg 473/2013; Article 5 TSCG. Reporting requirements include assessment of in-year budgetary execution, contingent liabilities, sub-sectors of government debt, and contemplates extensive internal audits on request of the Commission.
2621 Art 9(1)-(2) Reg 473/2013.
2622 Art 9(4) Reg 473/2013.
2623 ‘Particularly serious non-compliance’ is sanctionable (Art 5(1) Reg 1173/2011). Rec 20 of Reg 473/2013 makes clear that particularly serious non-compliance means non-compliance with the content of substantive recommendations.
2624 Art 8(1) Reg 1176/2011.
2625 Art 8 Reg 1176/2011.
2627 Art 8(3) Reg 1176/2011.
‘non-compliance’ and sanctioned where the ‘Member State concerned has not taken the corrective action recommended by the Council.’

For EMU Member States, initiation of the EDP and EIP is also accompanied by the possibility of sanctions at this stage. Under the EDP, if the Commission finds ‘particularly serious non-compliance’ with the obligations of the SGP, or if the country has already been fined under the preventative arm of the MSP, the Commission will recommend that the Council require a deposit of 0.2% of GDP. Under the EIP, if two corrective action plans are rejected in the same EIP, the Commission will, within 20 days, recommend that the Council issue a decision impose an annual fine of 0.1% of GDP. Under secondary EU law, both sanctions ‘will be considered adopted unless the Council decides to the contrary by QMV within ten days.’ Importantly, the QMV required to reject the Commission’s recommendation is the ‘super’ RQMV in Article 238(3)(b) TFEU, which requires 72% of the Member States comprising at least 65% of the population. The effect of ‘super’ RQMV in this area is discussed in Section 8.3.4.

8.1.4 Stage 4: Enhanced Surveillance

Compliance with the recommendation is monitored with different degrees of intensity depending on the procedure. For the MIP, monitoring and surveillance is folded into the ordinary cycle of surveillance of CSRs over the European Semester and the ‘preventative arm’ of the MIP as a distinct process effectively ends here. Under the MSP and EIP, Member States that are the subject of recommendations following the Commission ‘warning’ of a significant observed deviation from the MTO (MSP) or excessive imbalance (EIP) must report on the actions taken within the deadline and are subject to ‘enhanced surveillance,’ under which the Commission (in conjunction with the ECB) is authorised to undertake on-site, IMF-style surveillance missions.

Under the EDP, ‘enhanced surveillance’ does not yet begin, but the ‘two pack’ allows the Commission to actively intervene by addressing an autonomous recommendation to EMU countries ‘regarding full implementation of the measures provided for in the recommendation or decision to give notice’, as well as ‘the adoption of other measures.’ This is the first time that the Commission, an unelected body, can address economic policy prescriptions to a Member State without the involvement of the Council. This is significant since, as will be shown in Section 8.2.2,

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2628 See: Art 10(4) Reg 1176/2011 (The Council shall adopt a decision establishing ‘non-compliance’ where it has not taken ‘the recommended corrective action’) and Art 3(1) Reg 1174/2011.
2629 Art 5(1) Reg 1173/2011.
2630 Art 4(1) Reg 1173/2011.
2631 Art 5(1),(2)-(4) Reg 1173/2011. Unlike the fine in Art 4(1) Reg 1173/2011, the fine in Art 5(1) is non-interest bearing.
2632 Article 3(2)(a) Reg 1174/2011.
2636 Article 11(2) Reg 473/2013.
Articles 3, 4(1) and 6(1) of Reg 473/2013 bind Member States’ budgetary procedures, fiscal plans, and draft budgets to those recommendations.

8.1.5 Stage 5: No Effective Action or Non-Compliance

If the Commission finds that the state has failed to take the recommended action at the expiry of the deadline set out in the recommendation, it will recommend a decision establishing ‘no effective action’ or ‘non-compliance,’ setting out new deadlines for corrective action.\(^{2637}\) This decision is taken differently, and has different consequences under each procedure.

Under the MSP and EIP, the Commission decision establishing ‘no effective action’ or ‘non-compliance’ is deemed have been automatically adopted by the Council unless it decides, by simple majority (under the MSP) or reverse ‘super’ QMV (under the EIP), to reject the recommendation within ten days.\(^{2638}\) Under the EDP, Article 126 TFEU and Reg 1467/97 contemplate that the decision of ‘no effective action’ is taken by QMV.\(^{2639}\) However, Article 7 TSCG again intervenes to usurp this with a reverse–‘super’ QMV burden for Euro Member States.\(^{2640}\)

All of these decisions are accompanied by the possibility of sanctions for EMU Member States. Under the MSP and EDP, Articles 4-5 of Reg 1173/2011 state that the Commission shall recommend, within 20 days of the decision of ‘no effective action’, the adoption of a Council decision requiring an interest-bearing deposit of 0.2% of GDP.\(^{2641}\) Under the EIP, Article 3(1) of Reg 1174/2011 states that the Commission will recommend the imposition of an interest-bearing deposit of 0.1% of GDP on the bases that the Member State ‘has not taken the corrective action recommended by the Council.’\(^{2642}\) If two such decisions of non-compliance are adopted in the same procedure, the Commission will recommend that the Council convert the interest-bearing deposit into an annual fine of 0.1% of GDP.\(^{2643}\) Under all of these procedures, the decision to impose the fine is adopted automatically unless it is rejected or amended by reverse ‘super’ QMV within 10 days.\(^{2644}\)

8.1.6 Stage 6: Sanctions

Under the MSP and EIP, recurrent sanctions may be applied to recidivist Member States in the manner just described. The EDP, by contrast, advances to a final stage. Under the EDP, within two

\(^{2637}\) MSP: Arts 6(2), 10(2) Reg 1466/97 (para 4). EDP: If the Member State takes effective action within the deadline, the Council may abrogate the EDP (on the recommendation of the Commission) and any deposit lodged at the first stage will be returned Article 7 Reg 1173/3011. EIP: Article 10(3)-(4) Reg 1176/2011.

\(^{2638}\) Under the MSP: The commission shall immediately recommend to that the Council adopt, by QMV, a decision and recommendation establishing ‘no effective action’. If this is not so adopted within one month, the Commission will issue a second recommendation which is considered to be adopted automatically unless the Council votes by reverse ‘super’ QMV to reject it: Art 121(4) TFEU; Arts 6(2), 10(2) Reg 1466/97. Under the EIP: Art10(4) Reg 1176/2011.

\(^{2639}\) EDP: Article 126(8) TFEU; Art 4(1) Reg 1467/97.

\(^{2640}\) See: Section 8.3.4

\(^{2641}\) Art 4(1), 5 Reg 1173/2011. Some specifics on the use of fines is set out in Arts 8-10 Reg 1173/2011.

\(^{2642}\) Art 3 Reg 1174/2011.

\(^{2643}\) Article 3(3)(b) Reg 1174/2011.

months of the ‘no effective action’ decision, the Council will issue ‘notice’ to take the necessary measures under Article 126(9) TFEU, and as long as the Member State fails to comply with the terms of the notice issued, Reg 1467/97 states that the Council must decide to impose sanctions (Article 126(11) TFEU) no later than four months after the issuance of notice. Sanctions provided for under Article 126(11) must include a fine of up to 0.5% of GDP, and may also consist of additional disclosures on bond and securities issues, adjustments to European Investment Bank lending policy (now expanded to all types of structural funds), or yet another non-interest bearing deposit. Once again, primary EU law contemplates that the decisions to issue notice and require a fine under Articles 126(9),(11) TFEU are taken by ordinary QMV, but Article 7 TSCG intervenes to usurp this with a reverse-QMV burden for EMU countries.

8.1.7 Conclusion to the Overview: Limits of the EU Coordination Competence

As the EU has no competence in economic policy, all of these procedures rules are interpreted, monitored and enforced by the Commission and the Council under the Union’s ‘coordination competence’ under Articles 2(3) and 5(1) TFEU, upon the legal basis of Articles 121(6) TFEU and 126(14) TFEU. Article 121(6) TFEU empowers the Council to adopt regulations setting out detailed rules for two stages of the MSP: Commission monitoring under Article 121(3) TFEU and Council recommendations under Article 121(4) TFEU. Article 126(14) TFEU provides a legal basis for the adoption of rules and definition for the application of the Protocol on the EDP. Neither Article 121(6) or 126(14) TTFEU provide a legal basis for the amendment of national budgetary processes.

The limits of this competence must be emphasised before the analysis of the procedures below are embarked-upon: The EU has no competence to set national economic and fiscal policy objectives, nor determine the content and composition of government revenues and expenditures. Neither the

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2645 Notice will require a minimum annual improvement of the structural balance of at least 5% of GDP, and will indicate the specific measures necessary: Art 5(1) Reg 1467/97. The fine is provided for by Article 6 Reg 1173/2011. This is in addition to the (interest-bearing) 0.2% deposit levied for ‘no effective action’ under the MSP (Art 4(1) Reg 1173/2011); and the 0.2% (non-interest bearing) deposit levied under the first stage of the EDP (Art 5(1) Reg 1173/2011). If the Member State has already lodged a 0.2% non-interest bearing deposit, then this will be converted into a fine.

2646 And within 16 months of the initial 1 April and 1 October reporting dates (subject to adjustments for periods of exceptional circumstances) Arts 6-7, 10(2) Reg 1467/97.

2647 Art 11 Reg 1467/97 make fines mandatory whenever a Member State triggers sanctions under Article 126(11). The amount of the fine will comprise a fixed component of 0.2% of GDP and a variable component, amounting to 1/10 of the absolute value of the difference between the balance as a percentage of GDP and either the reference value for government balance or the government balance of GDP that should have been achieved under the notice: Art 12 Reg 1466/97. See also: Article 8 Reg 1173/2011.

2648 See: Section 8.3.4.

2649 Articles 121(3) and 121(4) TFEU allow the Council to monitor and address warnings to Member States where economic policies either ‘risk jeopardising the proper functioning of the EMU’ or are not consistent with the BEPGs.

2650 Art 126(14) TFEU states: ‘Subject to the other provisions of this paragraph, the Council shall, on a proposal from the Commission and after consulting the European Parliament, lay down detailed rules and definitions for the application of the provisions of the said Protocol.’

2651 Pringle v Ireland [64]; Brunner (Germany) [64], [91]; Gauweiler I (Germany) [39] (In this field of economic policy, the European Union is essentially limited to a coordination of Member States’ economic policies ... [T]he responsibility for economic policy lies clearly with the Member States’); De Nederlandsche Bank (2007) 27 (‘the transfer of sovereignty relates solely to the balance of revenues and expenditures, and not to their level of composition’).
Treaty debt targets nor the policies recommended to meet them are legally binding. Excessive deficits and debts above 3% or 60% of GDP are not prohibited under EU law, and the obligations to adhere to the MTO or correct ‘imbalances’ are found nowhere in the Treaties. Article 126(10) TFEU is clear that Member States may not be brought before the EU courts for infringement proceedings for failure to comply with the EDP.

Under this division of competences, surveillance and sanctions under EU law are justified because they set a political incentive framework for - yet are hived off from - the economic and social competences of Europe’s constitutional democracies. The federal bargain inscribed in Articles 2-5 and 122-125 of the TFEU was to was to hive-off the treaty-fixed dictates of price-stability from the rich economic and social lives inhabiting the exclusive fiscal competences of Europe’s constitutional democracies - ‘leaving the latter firmly in Member State hands while opening the former to supranational intervention.’ Those articles internalise the cost of economic and social policy choices and so obviate the need to govern them. That a national debt should become more costly at 60% of GDP is a political agreement inscribed in the Treaty as a clarion for markets; whether this should give way to healthcare or schooling is for the national parliament to decide. There is, in principle, no violation of the European legal order in so far as EU recommendations do not take automatic effect in national law and a failure to implement them does cannot lead to infringement proceedings.

‘So long as [country-specific recommendations] are simply ‘recommendations,’ their legal effects, and therefore their capacity to override limits prescribed in EU/national constitutional orders, is limited.

The abrogation of the ‘no bailout’ clause has ruptured this barrier. Permanent provision ‘has now been made for unlimited fiscal transfers between the euro-area States,’ and the costs of democratic choice are no longer internalised. In order to stem the dysfunctional cost-incentives identified in Chapter 3 and make the new model ‘work,’ Member States have been required to operationalise the

2652 See: Section 2.3.2.2. Hahn (1998), 85.
2653 Article 126(10) TFEU. See: Section 2.3.2.2. See also: Hahn (1998), 85.
2654 Art 126(10) TFEU states: ‘The rights to bring actions provided for in Articles 258 and 259 may not be exercised within the framework of paragraphs 1 to 9 of this Art.’
2655 Costamanga (2014), 360. Benoît Coeuré, ‘The importance of independent fiscal councils’ (Fiscal Councils, Central Banks and Sound Finances, Frankfurt am Main, 27 January 2016), explains: ‘Monetary policy is a technical task aimed at minimising market distortions and undesirable economic fluctuations. […] By contrast, fiscal policy has strong allocation and redistribution dimensions, which need to reflect national political preferences. Accordingly, fiscal policy has remained the innate prerogative of democratically elected governments. This is supported by the findings of the political-economy literature, which points to the need for limits on the delegation of these policies to independent experts.’
2656 Gauweiler II (Opinion of AG Cruz-Villalon) [131], ‘Articles 123-125 TFEU… confirm that monetary union, although it is an integral part of a Union founded on the value of solidarity (Art 2 TEU), also seeks to maintain financial stability, for which purpose it is based on a principle of fiscal discipline and the principle that there is no shared financial liability (the ‘no-bailout’ rule).’ See also Borger (2013), 118: underpinning the Treaty lie only two disciplinary forces: ‘self-restraint and market discipline.’
2658 Chalmers (2012).
EU’s fiscal rules in national fiscal frameworks and national constitutional law. The ‘six pack’ and ‘two pack’ instruments have not only broadened and deepened enforcement at EU level, they have stretched athwart the gap between legal orders and made amendments directly to national budgetary laws.

In order to assess such interlinkages, the remainder of this chapter proceeds in four sections, each of which conducts a detailed deconstruction of one of the four pillars of economic governance to identify instruments in conflict with Member State ‘constitutional identity’ or ‘ultra vires’ jurisprudence.

### 8.2 Binding Vertical Interlinkages with the European Semester

The first architecture analysed here is the system of vertical interlinkages with the European Semester. National budgetary frameworks are now integrated into the European Semester under the ‘six pack,’ and fortified with respect to EMU Member States by the ‘two pack.’ This timeline is designed to ‘enable the Commission to give policy guidance in good time before decisions are made at national level’.

Far from mere administrative convenience, this process is imbued with vertical effects because EU legislation has made extensive amendments to national fiscal frameworks which create binding interlinkages with the European Semester. Member States have been required to implement budgetary frameworks and technical requirements legislated by EU institutions into national law, and fiscal rules set out under the European Semester, the MSP and EDP are now embedded in national law under the ‘six pack,’ ‘two pack,’ and TSCG. Nor are these interlinkages limited to matters of procedural comity - they are interspersed with substantive content. The ‘integrated approach’ of the European Semester ‘enables the Commission and the Council to exert direct influence on the democratic legislative procedure of each Member State.

Yet the legal basis for the instruments that comprise the European Semester - Regulations 1466/97 and 473/2013, in conjunction with Directive 2011/85/EU – is Article 121(6) TFEU. Under that article, the Council is empowered to adopt regulations setting out detailed rules for two stages of the MSP: Commission monitoring under Article 121(3) TFEU and Council recommendations under

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2659 The European Semester established under Art 2-a Reg 1466/97 as amended by Art 1 Reg 1175/2011.
2660 Art 4 Reg 473/2013.
2661 European Commission, ‘The EU’s economic governance explained’ (2014) [emphasis added].
2662 Directive 2011/85/EU sets out extensive requirements for budgetary frameworks and national fiscal rules.
2663 Member State budgetary frameworks, medium-term fiscal plans, and draft budgets ‘shall be consistent with’ EU economic governance procedures under Arts 3, 4(1), 6(1) Reg 473/2013.
2664 Arts 3(1)(b) TSCG (the country-specific MTO to be enforced under national law is that defined in the SGP).
2665 Boggero and Annicchino (2014), 249.
Article 121(4) TFEU.\textsuperscript{266} It allows for the production of certain data for the operation of the MSP at EU level. It does not provide a legal basis to govern Member State legislative frameworks.

However, the legislation at issue in this section does not govern the operation of the European Semester at EU level – it legislates the content of budgetary processes at national level. So, for example, the objective of Regulation 473/2013 is ‘ensuring that Council and Commission recommendations are appropriately integrated into the budgetary procedure of the Member States.’\textsuperscript{2667} This is an important distinction. It is easy to see how Article 121(3) TFEU justifies the production information at specific junctures in order for the MSP to operate at EU level. It is less easy to say the same for legislation requiring specific EU policies at national level.

This section identifies two complex legal mechanisms of binding secondary EU legislation which bind constitutionally-endowed budgetary authorities in the exercise of their exclusive competences.

[8.2.1] First, a complex constellation of provisions under the ‘six pack’, ‘two pack’, and Regulation 379/2009 (as amended in 2015) amend national budgetary frameworks to ensure that the Commission’s technical definitions, forecasted outcomes, and appropriate MTO are automatically reproduced in national law and internalised into the budgetary process.\textsuperscript{2668} As will be shown, these constrain the choices of national budgetary decision-makers both ex-ante, at the stage of policy formulation, and ex-post, such that a failure to meet EU numerical targets will lead to a breach national laws implanted there by EU legislation.

[8.2.2] The second and most remarkable machinery studied here is what this thesis refers to as ‘the budgetary veto.’ This has two components. First, in near-identical terms, Articles 3, 4(1) and 6(1) of Reg 473/2013 state that Member State budgetary procedures, medium-term budgetary plans, and draft budgets themselves ‘shall be consistent with,’ inter alia, the general guidance and CSRs issued under Article 121(2) TFEU; any and all recommendations issued under Regulations 1466/97 (the MSP), 1467/97 (the EDP), 1176/2011 (the MIP/EIP), and 473/2013; and the Opinion on Economic Partnership Programmes under Reg 473/2013.\textsuperscript{2669}

\begin{footnotesize}
\textsuperscript{266} Art 121(3) TFEU reads: ‘In order to ensure closer coordination of economic policies and sustained convergence of the economic performances of the Member States, the Council shall, on the basis of reports submitted by the Commission, monitor economic developments in each of the Member States and in the Union as well as the consistency of economic policies with the broad guidelines referred to in paragraph 2, and regularly carry out an overall assessment. For the purpose of this multilateral surveillance, Member States shall forward information to the Commission about important measures taken by them in the field of their economic policy and such other information as they deem necessary.’ Art 121(4) TFEU reads: ‘Where it is established, under the procedure referred to in paragraph 3, that the economic policies of a Member State are not consistent with the broad guidelines referred to in paragraph 2 or that they risk jeopardising the proper functioning of economic and monetary union, the Commission may address a warning to the Member State concerned. The Council, on a recommendation from the Commission, may address the necessary recommendations to the Member State concerned. The Council may, on a proposal from the Commission, decide to make its recommendations public.’

\textsuperscript{2667} Reg 473/2013, rec 2, 12 (emphasis added).

\textsuperscript{2668} Directive 2011/85/EU sets out extensive requirements for budgetary frameworks and national fiscal rules, and Reg 473/2013 sets out extensive requirements for the content of Member State fiscal rules.

\textsuperscript{2669} Art 3(1), 7(1) Reg 1466/97 (as amended); Art 4(1) Reg 473/2013.
\end{footnotesize}
Second, under Article 7(2) of Regulation 473/2013, if the Commission identifies ‘particularly serious non-compliance’ with those obligations, it will deliver an ‘Opinion’ requesting that the budget be re-drafted.\footnote{Art 7(2) Reg 473/2013.} As Regulation 473/2013 cannot be interpreted in such a way that a national budget can be both ‘consistent with’ EU recommendations (for the purposes of Article 6) and in ‘serous non-compliance with’ those same EU recommendations (for the purposes of Article 7), a failure to take the legislated-for decision will, as will be shown, result in a breach of directly-applicable secondary EU law until the Commission approves the budget.

Combined with these strictures, the European Semester secures the Commission - a body with no legal competence for economic policy - a direct role in policy formulation and enforcement over a 12-month period \textit{before} they are presented to national parliaments. Section 8.2.3 evaluates these two systems under the constitutional identity and \textit{ultra vires} rulings identified in this thesis, as well as recent ECJ jurisprudence on what is and is not an EU act.

\section*{8.2.1 EU Legislation Binds Budgetary Frameworks to EU Macrofiscal Assessments}

The first legal machinery of concern in this chapter is a constellation of secondary EU law which binds Member States to substantive technical outputs set out by the Commission during the European Semester. Directive 2011/85/EU, applicable to all Member States, lays down detailed rules governing the content and processes of national budgetary frameworks. Article 2 of the Directive defines medium-term budgetary frameworks as ‘the set of arrangements, procedures, rules and institutions that underlie the conduct of budgetary policies of general government.’ This extends to all aspects of budgetary decision-making in the Member States, encompassing \textit{inter alia}: (a) statistical and accounting rules;\footnote{Art 3 Directive 2011/85/EU (Member State public accounting systems must be based on the ESA 95 standard).} (b) rules and procedures governing economic forecasts;\footnote{Art 4 Directive 2011/85/EU (economic forecasts must be compared against the Commission’s most likely assessments).} (c) numerical fiscal rules enforcing the 60\% debt, 3\% deficit, and MTO values;\footnote{Art 5 Directive 2011/85/EU (Member States must have numerical fiscal rules enforcing the 60\%, 3\% and MTO values).} (d) the budgetary enactment process; (e) the setting of policy priorities and MTOs;\footnote{Arts 9-10 Directive 2011/85/EU (on the setting of the MTO).} (f) independent councils for monitoring and compliance;\footnote{Arts 12-14 Directive 2011/84/EU (Member States must have independent councils for monitoring and compliance).} and (g) fiscal relationships between public authorities across sub-sectors of general government.\footnote{Art 2 Directive 2011/85/EU.} Directive 2011/85/EU intends, in no uncertain times, to bind Member States to EU-legislated frameworks, rules, assessment and macrofiscal outcomes:

\begin{quote}
\textit{‘Medium-term budgetary frameworks are strictly instrumental in ensuring that budgetary frameworks of the Member States are consistent with the legislation of the Union.’}\footnote{Rec 19, Directive 2011/85/EU (emphasis added).}
\end{quote}
No issues of fiscal sovereignty arise in so far as elected budgetary executives remain legally free, as a matter of EU law, to prefer their own macrofiscal assessments or disregard others altogether when formulating policy.\textsuperscript{2678} Without exception, Europe’s constitutional democracies guarantee citizens the right to elect a government to ‘tear up’ European economic policy prescriptions, ignore the ‘troika’, or take decisions purely on subjective social factors instead of independent economic forecasts.\textsuperscript{2679} Monitoring under the ‘open method of coordination’ has long been justified as assisting Member States in evaluating their own efforts, without supplanting the national assessment or the policy implications to be derived therefrom.\textsuperscript{2680}

In that regard, the legal bases for EU legislation requiring the production or harmonisation of data are typically justified on two grounds: (1) That the data is directly necessary for the exercise of one of the competences of the Union; or (2) the data merely informs national policy-makers under EU-level coordination procedures.\textsuperscript{2681} Regulations 2223/96 & 549/2013 (European system of accounts), 223/2009 (on European Statistics), and 99/2013 (the European Statistical Programme), for example, are established under Article 338 TFEU, a competence to ‘adopt measures for the production of statistics where necessary for the performance of the activities of the Union.’\textsuperscript{2682} Similarly, Reg 479/2009 (statistics for the application of the EDP) was established under Article 126(14) TFEU for the purposes of applying EDP – a political mechanism. None of these alter technical assessments for the purposes of national law, or create rules which bind Member State to particular statistical indicators.

The web of technical legislation picked-apart in this section is different. Amendments to national budgetary frameworks under the ‘six pack’, and ‘two pack’, have linked EU technical assessments to fiscal rules implanted there by EU legislation in a manner that can automatically define policy choices in a way which goes beyond mere benchmarking.

\textsuperscript{2678} Note that this does not preclude the Member State from enacting a law which internalises the EU’s budgetary objectives. Nor does it preclude the Union levying political or financial sanctions on the Member State. All that is precluded is the Union creating a legally-binding duty to follow EU law dictates in economic policy when exercising exclusive Member State competences.


\textsuperscript{2681} See, e.g., Reg 549/2013, rec 1: ‘Whereas: Policymaking in the Union and monitoring of the economies of the Member States and of the [EMU] required comparable, up-to-date and reliable information on the structure of the economy and the development of the economic situation of each member State or region.’

The MTO is expositive. The MTO is a numerical value which, as will be shown, becomes the overarching objective of the Member States’ entire budgetary policy, and takes on both constitutional and ‘hard law’ effects in national law under Article 3 TSCG, Article 5 Directive 2011/85/EU, Article 2a of Reg 1466/97, and Articles 3-4 and 6 of Reg 473/2013. Yet this objective is calculated according to a common mathematical formula at EU level. This means the objective of the budget is the numerical sum of the numbers put into it, not the outcome of political choice by elected officials. As the Council Statistical Programme states:

‘the nature of statistics has changed. They are no longer merely one source of information for policy-making purposes, but are now at the very heart of the decision-making process.’

The question therefore arises: Are Member States legally free, as a matter of EU law, to arrive at their own macrofiscal assessments of the macrofiscal medium-term objective or disregard them in favour of other political objectives? This section deconstructs a legal machinery which precludes just that. It binds elected budgetary executives to EU technical assessments implanted into national budgetary frameworks by secondary EU law. This machinery has three components.

**8.2.1.1 Component 1: Elected Budgetary Executives are Bound to EU Technical Frameworks**

The first component of this machinery is Article 4(1) in conjunction with Article 10 of Directive 2011/85/EU. Article 4(1) states that national budgetary planning must be ‘based on the most likely macrofiscal scenario or a more prudent scenario,’ compared and updated against ‘the values contained in the Commission’s forecasts’ under a ‘comply or explain’ principle. Article 10 then

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2683 See: Section 8.2.2.
2684 See: Section 8.3.2.1. Art 3(1)(b) TSCG states that the [balanced- budget] rule under point (a) shall be deemed to be respected if the annual structural balance of the general government is at its country-specific medium-term objective, as defined in the revised Stability and Growth Pact.’
2685 See: Section 8.3.3. Art 5(b) Directive 2011/85/EU states that ‘Each Member State shall have in place numerical fiscal rules which are specific to it and which effectively promote compliance with its obligations deriving from the TFEU … in particular: (b) adherence to the Member State’s medium-term budgetary objective.’
2686 See: Section 8.3.3. Art 2a Reg 1466/97 states that ‘Each Member State shall have a differentiated medium-term objective for its budgetary position. […] The respect of the medium-term budgetary objective shall be included in the national medium-term budgetary frameworks in accordance with [Directive 2011/85/EU].’
2687 See: Section 8.2.2. Those articles state, in near identical terms, that fiscal plans, budgetary frameworks, and draft budgetary plans shall be consistent with any and all recommendations issued under Regulations 1466/97, 1467/97, 1176/2011, and 473/2013; and the Opinion on EPPs under Article 9 of Reg 473/2013.
2690 Art 4(1) Directive 2011/85/EU states: ‘Budgetary planning shall be based on the most likely macrofiscal scenario or on a more prudent scenario. The macroeconomic and budgetary forecasts shall be compared with the most updated forecasts of the Commission and, if appropriate, those of other independent bodies. Significant differences between the chosen macrofiscal scenario and the Commission’s forecast shall be described with reasoning, in particular if the level or growth of variables in external assumptions departs significantly from the values contained in the Commission’s forecasts.’ I.e, this means compared against the Commission’s Country Reports and winter forecasts.
states that the actual budget legislation produced by the Member State must be consistent with the medium-term budgetary framework legislated by the directive.\footnote{1} This means that the Member States cannot freely depart from the Commission’s assessment of the economic situation and the implications for reform. Member States are bound to the most-likely macrofiscal scenario produced by the budgetary framework, and the macrofiscal scenario produced must be compared and updated against the Commission’s macrofiscal assessment. As the Commission \textit{Vade mecum} states, this is a clear and precise legal obligation: ‘the precise requirement of Reg 1466/97 is that they must be based on the most likely macro-fiscal scenario or on a more prudent scenario.’\footnote{2} If the national forecasts align with those of the Commission, the Member State is \textit{prohibited by EU law} from choosing the second-most likely scenario.\footnote{3} If the government chooses to base its budgetary legislation on a different scenario altogether, this will result in a failure to implement secondary EU law. Furthermore, as the Directive 2011/85/EU is enacted using Article 126(14) TFEU, non-compliance is not excluded from infringement proceedings. Article 126(10) TFEU only excludes paragraphs (1)-(9) from infringement proceedings.\footnote{4} This leads to curious result: While the 3\% and 60\% limits in the Treaty are not legally binding and cannot be subject to infringement proceedings, there is nothing to exclude a Member State being brought before the ECJ for failure to base its \textit{internal budgetary enactment process} on the ‘most likely’ fiscal scenario produced by the Commission or the budgetary framework imposed under Directive 2011/85/EU.

\textbf{8.2.1.2 Component 2: Member State Fiscal Institutions are Bound to EU Technical Assessments}

Articles 6(1)(b) of Directive 2011/85/EU and 4(4) of Reg 473/2013 then add a second component to this machine. Those articles state that Member State draft budgets and fiscal plans must be based on macrofiscal assessments produced or endorsed by independent bodies.\footnote{5} Article 4(4) of Reg 473/2013 states that ‘National medium-term fiscal plans and draft budgets […] shall be based on independent macroeconomic forecasts.’ Article 2(1)(b) then defines ‘independent macroeconomic forecasts’ as ‘forecasts \textit{produced or endorsed} by independent bodies,’ and Article 2(1)(a) defines ‘independent bodies’ as:

\begin{itemize}
  \item \textbf{Art 10\footnote{6} Directive 2011/85/EU states: ‘Annual budget \textit{legislation} shall be consistent with the provisions of the medium-term budgetary framework. Specifically, revenue and expenditure projections and priorities resulting from the medium-term budgetary framework as set out in Article 9(2) shall \textit{constitute the basis for the preparation of the annual budget}. Any departure from those provisions shall be duly explained.’ (Emphasis added) It should be noted that the budgetary framework required under Article 9(2) must, of course, be based on the forecasts required under Article 4.}}\footnote{7} \textit{Vade mecum’ (2013), 35.}
  \item \textbf{Only if the most likely forecast of an independent fiscal council differs from the Commission can that scenario be chosen (subject to comply or explain), but to the extent they match, it will be bound to it.}
  \item \textbf{Article 126(10) TFEU excludes violations of the 3\% deficit and 60\% deficit rules from being subject to infringement proceedings, but only applies to Arts 126(1)-(9) TFEU. It states: ‘The rights to bring actions provided for in Articles 258 and 259 may not be exercised within the framework of paragraphs 1 to 9 of this Article.’}
  \item \textbf{Article 5 Reg 473/2013; \textit{Art} 4(4) of Reg 473. \textit{Art} 6(1)(b) Directive 2011/85/EU states that country-specific fiscal rules shall include ‘the effective and timely monitoring of compliance with the rules, based on reliable and independent analysis carried out by independent bodies…’}
\end{itemize}
‘bodies that are structurally independent or bodies endowed with functional autonomy vis-à-vis the budgetary authorities of the Member State, and which are underpinned by national legal provisions ensuring a high degree of functional autonomy and accountability.’

In short, Member States cannot have draft budgets or fiscal plans which are not written or approved by independent bodies established by EU law. Once again, this poses no constitutional difficulties for this thesis so long as the fiscal institution’s macrofiscal assessments are their own and where they do not have automatic legal effects binding on Member State budgetary authorities. However, neither is the case.

First, these ‘independent’ fiscal councils are legally, functionally and financially connected to EU institutions. They: (1) derive their existence and mandates from secondary EU legislation; 2697 (2) they fall under the purview of a ‘European Fiscal Board’ established by the Commission to ‘coordinate national fiscal councils’; 2698 (3) they are governed by a new ‘National Statistical Institute’ (NSI), 2699 which operates as central ‘coordinating authority’ with ‘sole responsibility for deciding on processes, statistical methods, standards and procedures’ and is the primary contact for the Commission; 2700 (4) they are required to engage in a ‘permanent technical dialogue’ with the Commission to ‘ensure consistency’ in their ‘independent macroeconomic forecasts’; 2701 (5) they are subject to direct technical assistance, targeted financial grants, and ‘any other interventions needed’ by the Commission; 2702 (6) they must calculate public accounts using an inventory of methods, procedures and sources adopted by the Commission; 2703 (7) the Commission is empowered to take binding

2696 Arts 4(4), 2(1)(a), (b) of Reg 473/2013.
2697 As rec 18 of Reg 473/2013 states, ‘The rules which those bodies should comply, and their specific tasks, are set out in this Regulation.’ See also: Art 4 Directive 2011/85/EU (requiring independent bodies for the preparation of forecasts); Arts 5 Reg 473/2013, Art 6(1)(b) Directive 2011/85/EU (requiring independents bodies empowered to monitor and trigger fiscal rules); Art 5 Reg 223/2009 (establishing National Statistical Institutes (NSIs) empowered to govern national statistical authorities). The ECB, for example, argues that the mandates of several fiscal councils are not coherent with the mandate in Reg 473/2013, because they allow the government to proceed on the basis of a forecast which the fiscal council disagrees. ECB, ‘Fiscal Councils in EU Countries’ (2014), 98. ([A] procedure should be specified, including a deadline for action and provisions of details on the potential consequences. Thus, a negative decision by the fiscal council should trigger a review of the forecasts, which would go beyond the “comply or explain” principle.’
2700 Art 5(1)(a) and 5(a)(3) Reg 223/2009, as amended by Art 1(2) Council Reg (EU) 2015/759: Member states are required to ‘ensure that other national authorities responsible for the development, production and dissemination of European statistics carry out such tasks in accordance with the national guidelines produced by the head of the NSI.’
2701 Art 4(5) of Directive 2011/85 EU establishes the duty, and Art 2(1) of Reg 473/2013 transfers it to the independent bodies: ‘In order to ensure consistency across the independent macroeconomic forecasts, the Member States and the commission shall, at least annually, engage in a technical dialogue concerning the assumptions underpinning the preparation of macroeconomic forecasts in accordance with Article 4(5) of Directive 2011/85/EU.’
2702 Arts 8, 10 Reg 99/2013. See: rec 21: ‘appropriate funding’ should be given to ‘individual statistical actions aimed at implementing the multiannual programme, including actions taking the form of an agreement between the national statistical authorities and the Commission.’
2703 Art 9(2)of Reg 479/2009.
decisions regarding the interpretation of those methods, procedures and sources;\textsuperscript{2704} (8) statistical institutions are subject to direct supervision by the Commission to ensure quality and compliance;\textsuperscript{2705} (9) they are subject to on-site ‘dialogue’ and ‘methodological’ visits to review data, monitor processes, verify accounts, and assess compliance;\textsuperscript{2706} (10) the Commission is empowered to ‘conduct all investigations necessary’ to investigate non-compliance;\textsuperscript{2707} (12) if the Commission finds misrepresented debt and deficit data, the Member State may be fined;\textsuperscript{2708} and (13) under Article 15 of Reg 479/2009, the Commission may unilaterally re-write data where there are unresolved methodological disagreements between the NSI and the Commission.\textsuperscript{2709} It is no small irony that EU legislation has created ‘independent’ bodies which are bound to the Commission by all the criteria which render them independent from Member States.\textsuperscript{2710}

Second, these technical assessments have demonstrable legal effects. Since medium-term fiscal plans and national draft budgets must be based on the macrofiscal scenario produced under Article 4(1) of Directive 2011/85/EU, and this assessment must be produced or endorsed by the Commission’s ‘independent bodies,’ elected governments are no longer free to make their own assessment of which scenario to follow at all. A budgetary framework which allows the government to proceed on the basis of its own assessment of the appropriate macrofiscal scenario will thus be in breach of Article 4(4) of Reg 473/2013 (for failing to adopt a budget endorsed by the independent body) and Articles 4(1) and 10 of Directive 2011/85/EU (for failing to legislate the budgetary framework and legislation on the basis of the most likely scenario).

The 2015 dialogue between Ireland’s NSI and the Commission under Reg 479/2009 is instructive. In 2015, Ireland’s NSI concluded that Ireland’s water utility, Irish Water, should not be classified under the government sector according to the ESA rules.\textsuperscript{2711} The Commission disagreed.\textsuperscript{2712} This led to a terse exchange in which the NSI found that the Commission’s assessment suffered from factual

\textsuperscript{2704} Art 10(1) Reg 479/2009: ‘In the event of a doubt regarding the correct implementation of the ESA 95 accounting rules, the Member State concerned shall request clarification from the Commission (Eurostat).’
\textsuperscript{2705} Art 8(1) Reg 479/2009.
\textsuperscript{2706} Art 11a-11b Reg 479/2009.
\textsuperscript{2707} Art 8(3) Directive 1173/2011.
\textsuperscript{2708} art 8 Directive 1173/2011. Fines shall not exceed 0.2% of GDP and are adopted by the Council under reverse-QMV.
\textsuperscript{2709} Art 15(2) Reg 479/2009 states: ‘The Commission (Eurostat) may amend actual data reported by Member States... where there is evidence that actual data reported by Member States do not comply with the requirements of Article 8(1).’ Under Art 8(1) Reg 479/2009, ‘Quality of actual data means compliance with accounting rules, completeness, reliability, timeliness and consistency of the statistical data.’ Specifically, this includes where Member States make unilateral changes to the sources and methods for estimating the deficit and debt set out in the inventory (Art 11(3)(b)); or where there are outstanding methodological issues between the Member State and the Commission (Art 11(3)(s)).
\textsuperscript{2710} Interestingly, the Commission’s fiscal board does not meet the requirements which the ECB considers necessary for national fiscal councils, in that the former binds the Commission only on a ‘comply or explain’ basis. Nor does it meet the same standards for independence which the ECB considers to be necessary at Member State level: ECB, ‘Fiscal Councils in EU Countries’ (2014), 98. Cf. ECB, ‘The creation of a European Fiscal Board’ (2015), 30.
\textsuperscript{2712} Eduardo Barredo Capelot, Follow up of the EDP dialogue visit to Ireland at November 2014 - Classification of Irish Water (2015 April 1).
inaccuracies, 2713 was ‘difficult to understand,’ 2714 and that its approach ‘introduced an element of subjectivity […] that [the NSI] did not feel would be appropriate to make.’ 2715 It concluded: ‘Having reviewed the structures of Irish Water we cannot accept [the Commission’s] conclusion.’ 2716

However, Article 10 of Reg 479/2009 empowers the Commission to take decisions regarding the application of the ESA, and the ESA Regulation is binding on Member States. The NSI was therefore required to reproduce the technical assessment of the Commission (with which it thoroughly disagreed). 2717

That this resulted in over €600 million being added to the government deficit for the purposes of Reg 479/2009, 473/2013 and Directive 2011/85/EU at EU level is relatively uncontroversial. 2718 What brings this into the realm of the remarkable, however, is that this does not just result in €600m for the SGP at EU level, but under Member State budgetary laws implanted there by EU legislation. 2719 It must be recalled that Ireland’s budgetary-decision makers are legally bound, by Directive 2011/85/EU and Article 4(4) of Reg 473/2013, to base their budgetary frameworks and draft budgets plans on economic forecasts ‘produced or endorsed by independent bodies.’ The ECB interprets this as giving the ‘independent’ fiscal councils a budgetary veto. 2720 The Irish NSI was therefore required to reproduce the Commission’s assessment of the appropriate MTO adjustment path, and the Irish budgetary executive was required to enact a budget which reproduced the MTO adjustment path of the NSI. This drags a budgetary obligation which is not binding under the Treaty (the SGP is a political mechanism) into the realm of binding law.

8.2.1.3 Component 3: Member State Fiscal Rules are Bound to EU Technical Assessments

It is here that a third component completes the circle. That is the role of Member State NSIs in national fiscal rules inserted there by Directive 2011/85/EU and Reg 473/2011. The operation of


2717 Letter from Jennifer Banim, Central Statistics Office to Eduardo Capelot, European Commission (5 August 2015): ‘We have not identified any guidance in the legal text of ESA 2010 and related manuals that would change our interpretation.’

2718 Ireland’s 2015 Stability Programme lamented that the classification of Irish Water was taken by the Commission through a ‘closed process.’: Ireland, Department of Finance, Stability Programme April 2015 (2015), 15.


2720 Frameworks that allow the government to proceed on assessments not approved by the fiscal council on a mere ‘comply or explain’ principle are not ‘fully in line’ with Reg 473/2013: ECB, 'Fiscal Councils in EU Countries' (2014), 98.
those fiscal rules is examined shortly in Sections 8.3.3 and 8.3.2, however for present purposes it is sufficient to remark upon the role of independent fiscal councils in their operation: Member States are required by EU law to (i) establish fiscal rules in national law, which (ii) enforce the MTO established under EU law, (iii) under supervision of ‘independent’ fiscal councils mandated and implanted there by EU law.

First, under Articles 6(1)(b) of Directive 2011/85/EU and 5(1) of Reg 473/2011, it is the ‘independent’ statistical bodies which are responsible for monitoring compliance with the MTO as well as the numerical fiscal rules which Member States are required to transpose into national law under Article 5 of the Directive 2011/85/EU (the operation of these rules is discussed in Section 8.3.3).\(^\text{2721}\)

Second, under Article 5(1)(a) of Reg 473/2013, it is the ‘independent’ fiscal bodies which are responsible for triggering the constitutional correction mechanism of the TSCG, which incorporates, into in the national budgetary process, the MTO ‘as established in Article 2a Reg 1466/97.’\(^\text{2722}\)

Furthermore, under Article 5(2)(a) Reg 473/2013, the ‘independent’ fiscal body is required to make that assessment on the basis of an assessment made by the Commission under Article 6(2) of Reg 1466/97.\(^\text{2723}\) (The operation of this rule is discussed in Section 8.3.2.)

Under these procedures, the Commission can be assured that if an elected budgetary executive somehow arrives at their own medium-term macrofiscal objective, in violation of the rules above, the Commission’s chosen MTO will be enforced against that executive by the EU-legislated fiscal councils, using EU-legislated fiscal rules, on the basis of EU-legislated numerical triggers.

8.2.1.4 Assessment: A Restriction on Budgetary Executives Beyond the EU Legal Order

An elected budgetary executive who sits down to map out the appropriate macrofiscal policy for her country will find herself hemmed-in by an inescapable pathway bound by secondary EU law. Ex-ante, national executives are legally bound, under Directive 2011/85/EU and Reg 473/2013, in combination with supervision and enforcement by the Commission under Regs 479/2009,\(^\text{2724}\)

\(^\text{2721}\) Art 6(1)(b) Directive 2011/85/EU reads: ‘1. Without prejudice to the provisions of the TFEU concerning the budgetary surveillance framework of the Union, country-specific numerical fiscal rules shall contain specifications as to … (b) the effective and timely monitoring of compliance with the rules, based on reliable and independent analysis carried out by independent bodies or bodies endowed with functional autonomy vis-à-vis the fiscal authorities of the Member States.’ Art 5(1) Reg 143/2013 states: ‘(1) Member States shall have in place independent bodies for monitoring compliance with: (a) numerical fiscal rules incorporating in the national budgetary processes their [MTO] as established in Article 2a of Regulation (EC) No 1466/97; (b) numerical fiscal rules as referred to in Art 5 of Directive 2011/85/EU.’

\(^\text{2722}\) Art 5(1)(a), ibid.

\(^\text{2723}\) Article 5(2)(a) of Reg 473/2013 states: ‘Those bodies shall, were appropriate, provide public assessments with respect to national fiscal rules, inter alia relating to: The occurrence of circumstances leading to the activation of the correction mechanism for cases of significant observed deviation from the medium-term objective or the adjustment path towards it in in accordance with Article 6(2) of Regulation (EC) No Reg 1466/97’ (i.e. the Commission’s autonomous assessment and warning under the MSP - see Section 8.3.1.3).

\(^\text{2724}\) Arts 11-11c Reg 479/2009.
to base the budgetary framework and budgetary legislation upon the macrofiscal assessments of (EU-legislated) ‘independent bodies’ which are themselves legally-required to replicate Commission technical assessments. To the extent that the Commission’s technical assessment as to the appropriate MTO is reproduced by the NSI, it will take precedence over the entire budgetary procedure and bind the government ex-post under fiscal rules imposed by Directive 2011/85/EU (see Section 8.3.3); binding requirements for budgetary policy under Reg 473/2013 (see Section 8.2.2); and the constitutional correction mechanism of the TSCG (see Section 8.3.2).

If Member State budgetary executives are bound (under binding secondary EU law) to macrofiscal assessments which are, for all intents and purposes, also acts of EU law, this would raise the prospect of an ultra vires breach going to the heart of fiscal sovereignty. The question then becomes: Are the macrofiscal assessments produced by EU-legislated fiscal councils acts of EU law?

According to the recent decision of the ECJ in *James Elliott Construction v Irish Asphalt*, the answer is yes. *Irish Asphalt* concerns the so-called ‘New Approach’ of technical harmonisation under Directive 89/106 (since replaced by Reg 305/2011), and is the first case considering the relationship of ‘independent private-law standards bodies’ (ISB’s) to EU law. Under that regime, the Commission asks private-law (non-EU) ISBs to draw up standards for the technical characteristics of industrial products. If the ISB chooses to accept the mandate, it may then draw-up the relevant standard, and the Commission may publish a reference to the standard in the Official Journal. Products meeting those standards enjoy a presumption of conformity with the Directive. In *Irish Asphalt*, the Irish Supreme Court asked the ECJ to consider whether technical standards issued by an

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2727 Art 5(2)(a) of Reg 473/2013 states that the ‘independent bodies’ shall assess the need to activate the correction mechanism under the Fiscal Compact ‘in accordance with Art 6(2) [Reg 1466/97]’ - a provision which refers to the assessment of a ‘significant observed deviation’ by the Commission.
2728 Arts 2, 5 Directive 2011/85/EU state that medium-term budgetary frameworks must promote compliance with (a) statistical and accounting standards for fiscal data; (b) rules and procedures governing economic forecasts; (c), the 60% debt, 3% deficit, and appropriate MTO adjustment path of -0.5% as a benchmark; (d) procedural rules governing the budgetary enactment process; (e) medium-term budgetary frameworks including the setting of policy priorities and MTOs; (f) independent councils for monitoring and compliance; and (g) mechanisms that regulate fiscal relationships between public authorities across sub-sectors of general government.
2729 Arts 3, 4, 6 of Reg 473/2013.
2730 Under Article 3(1)(b) TSCG, compliance with the balanced budget rule will be achieved where ‘the annual structural balance of the general government is within its country-specific MTO as defined in the Stability and Growth Pact.’
2731 Case C-613/14 *James Elliott Construction Limited v Irish Asphalt Limited* (Third Chamber, 27 October 2016).
2733 Art 7 Directive 89/106/EEC.
ISB under the Directive 89/106 framework are acts of EU institutions, bodies and offices which are part of the Union *acquis*. 2735

It is important to remark the parallels and differences between the ISB context and the macrofiscal assessments of NSIs in this context. Both play a similar role their respective regimes: creating technical standards incorporated into an EU-legislated legal framework. However ISB’s are, first, independent private bodies which can autonomously accept or refuse mandates issued by the Commission. This is unlike the fiscal councils in this section, which derive their existence and mandates from EU law, and which are not autonomous (they cannot choose to accept or refuse to produce certain statistics, for example). Second, the ‘New Approach’ directive is not mandatory: ISBs can develop their own standards or refuse the Commission’s specifications, and economic operators can choose to follow them or not. This is unlike the fiscal institutions in this chapter which - as evidenced by the Irish Water saga - have no choice as to whether or not to follow the requirements of the Commission when producing macrofiscal and accounts data. Third, ISB standards do not take on legal effects unless the Commission selects them, and operators are not bound to those standards which are approved. This is unlike the macrofiscal assessments produced by ISBs, which are binding on budgetary executives *ex-ante*, and do trigger EU-legislated fiscal rules *ex-post*.

In *Irish Asphalt*, the ECJ held that such technical outputs were acts of EU law. This was so according to a three-stage test. 2736 First, the ECJ concluded that ISB standards “while indeed adopted by bodies which cannot be described as “institutions, bodies, offices or agencies of the union” *are by their nature measures implementing or applying an act of EU law,* and *provisions forming part of the European legal system.*” 2737 Second, the court found that the technical standards were not truly independent, but “*strictly governed by the essential requirements defined by that directive, initiated, mandated and monitored by the Commission.*” 2738 Third, the work of the technical bodies was mandated by EU law; 2739 it was “*initiated, managed and monitored by the Commission;*” 2740 it was “*subject to detailed monitoring by the Commission*”; 2741 and they acquired their legal effects as a consequence of their incorporation into acts of EU law. 2742

Applying all or even one of these tests, it is impossible to avoid the conclusion, *a fortiori*, that the technical assessments which bind elected budgetary executives in this chapter are also acts of EU *law*.


2736 See also: A similar approach was adopted in Case C-171/11 *Fra.bo SpA v Deutsche vereinigung des Gasund Wasserfasches (DVGW)* (Fourth Chamber, 12 July 2012).

2737 *Irish Asphalt* [34]. See also: *Irish Asphalt* (Opinion of AG Sánchez-Bordona) [44]-[45] the Directive ‘is directly connected to [the technical standard],’ and therefore formed part of the legal regime which the directive established.’

2738 *Irish Asphalt* [43]. See also: *James Elliott v Irish Asphalt* (Opinion of AG Sánchez-Bordona) [41], [55].

2739 *Irish Asphalt*, [44].

2740 *Irish Asphalt*, [43].

2741 *Irish Asphalt*, [45].

2742 *Irish Asphalt*, [43] See also: *Irish Asphalt* (Opinion of AG Sánchez-Bordona) [56]-[58].
law. The ‘independent’ fiscal bodies are established, governed, and incorporated under the European legal system under Directive 2011/85/EU, Reg 473/2013, Reg 479/2009, Reg 223/2009, and Reg 1173/2011;'\textsuperscript{2743} they are ‘strictly governed by the essential requirements defined by that directive, initiated, mandated and monitored by the Commission’; \textsuperscript{2744} macrofiscal assessments of fiscal institutions are mandated, managed, and subject to detailed monitoring by the Commission;\textsuperscript{2745} and they acquire their legal effects as a consequence of their incorporation into acts of EU law.\textsuperscript{2746}

This must, by necessity, constitute a manifest excess of the European legal order. It must be recalled that the legal basis for Directive 2011/85/EU and Regulation 473/2013 is Article 121(6) TFEU, which allows the Council to set out rules for the production of statistics for use in two stages of the MSP procedure at EU level: Commission monitoring under Article 121(3) TFEU and Council recommendations under Article 121(4) TFEU. It does not provide a legal basis to bind Member States to macrofiscal assessments of EU institutions. And yet, as will be shown below, this machinery grips each link in the ‘chain of legitimation’ shielded from restriction under Article 79(3) of the German Basic Law in a manner which violates the ‘constitutional identity’ test applied in this thesis.\textsuperscript{2747} The framework intervenes to delimit each stage of the decision-making process for the drafting of a budget; it is not optional; the budgetary executive is not accountable to the Member State parliament in the development of its macrofiscal assessments or objectives; and - taking the form of a Regulation and Directive - and it cannot be reversed by an equivalent action of the Member State parliament in the future.

\textbf{8.2.2 EU Legislation Binds Substantive Budgetary Policies: The Budgetary Veto}

The second significant legal machinery inter-twined with the European Semester is a remarkable system referred to herein as the ‘budgetary veto.’

Under Regulation 473/2013, Member States are required to submit their planned economic and budgetary policies for inspection by 20 April each year,\textsuperscript{2748} internalise CSRs regarding their economic and fiscal policies ‘before taking key decisions on their national budgets,’\textsuperscript{2749} and submit their draft budgets to the Commission for approval by 15 October each year. The stated objective of this instrument is ‘ensuring that Council and Commission recommendations are appropriately integrated into the budgetary procedure of the Member States,’ and ‘to ensure that Union policy

\textsuperscript{2743} Cf. Irish Asphalt [34]; Irish Asphalt (Opinion of AG Sánchez-Bordona [10], [39].

\textsuperscript{2744} Cf. Irish Asphalt [43].

\textsuperscript{2745} Cf. Irish Asphalt [44]-[45] ‘the work of the standardisation organisations must be subject to detailed monitoring by the Commission alongside an obligation duly to report to the Commission along with confirmation by that institution of the compliance of the final drafts of the harmonised standard.’

\textsuperscript{2746} Cf. Irish Asphalt, [43]; James Elliott v Irish Asphalt (Opinion of AG Sánchez-Bordona [56]-[58] noting that the ISB owes its mandate to the Commission; its activities in relation to harmonised technical standards ‘are based on cooperation with the Commission governed by an agreement in the form of certain general guidelines, periodically reviewed’; and the Commission gives financial support to the ISBs for the issuance of harmonised technical standards.

\textsuperscript{2747} See: Infra Figure 1, Section 1.3.1.1, p 83.

\textsuperscript{2748} Arts 2-2a(2)(d)4, 5 Reg 1466/97 (as amended); Art 4(1) Reg 473/2013.

\textsuperscript{2749} Art 2-a(3) Reg 1466/97 (as amended).
recommendations in the budgetary area are appropriately integrated in the Member State budgetary preparations.  

In near-identical terms, Articles 3, 4(1) and 6(1) of Reg 473/2013 then state that EMU Member States’ budgetary procedures (Article 3), medium-term fiscal plans (Article 4(1)), and draft budgets themselves (Article 6(1)) ‘shall be consistent with,’ inter alia: any and all ‘recommendations issued in the context of the SGP’ and ‘recommendations issued in the context of the annual cycle of surveillance, including the macroeconomic imbalances procedure as established by Regulation (EU) No 1176/2011,’ including, but not limited to, all recommendations issued under Regulations 1466/97 (MSP), 1467/97 (EDP), 1176/2011 (MIP/EIP), 473/2013 (the two pack) and the Opinion on EPPs under Article 9 of Reg 473/2013, in the context of the European Semester. Then, under Article 7(2) of Regulation 473/2013, if the Commission identifies ‘particularly serious non-compliance’ with those obligations, it will deliver an ‘Opinion’ to that effect, requesting that the Member States’ budget be re-drafted.

This section will demonstrate that the interaction of these four articles has given the Commission the trigger for a mechanism that binds Member State budgetary policies directly, such that failure to internalise or secure the EU legislated-for substantive outcome will lead to a breach of EU law itself.

8.2.2.1 Component 1: Inconsistent Draft Budgetary Plans

The first component of this mechanism is Article 6(1) of Reg 473/2013. It states:

‘Member States shall submit annually to the Commission and to the Eurogroup a draft budgetary plan for the forth-coming year by 15 October. That draft budgetary plan shall be consistent with the recommendations issued in the context of the SGP and, where applicable, with recommendations issued in the context of the annual cycle of surveillance, including the macroeconomic imbalances procedure as established by Regulation (EU) No 1176/2011, and with opinions on the economic partnership programmes referred to in Article 9.’

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2750 Reg 473/2013, rec 12. See also: Art 1(c) It is ‘to ensure that Union policy recommendations in the budgetary area are appropriately integrated in the Member State budgetary preparations.’ See also: Rec 2: ‘ensuring that Council and Commission recommendations are appropriately integrated into the budgetary procedure of the Member States.’

2751 Arts 3(2)-(3), 4(1), 6(1) Reg 473/2013. This encompasses the AGS, AMR, Employment Guidelines, CSRs, Country Reports and any other economic outputs under Article 121(2) TFEU. Arts 3(1), 4(1) Reg 473/2013 and this also encompasses the autonomous Commission recommendation under the EDP See: Section 8.1.5.

2752 Art 7(2) Reg 473/2013: ‘where, in exceptional cases, after consulting the Member State concerned within one week of submission of the draft budgetary plan, the Commission identifies particularly serious non-compliance with the budgetary policy obligations laid down in the SGP… the Commission shall request that a revised draft budgetary plan be submitted as soon as possible and in any event within three weeks of the date of its opinion.’

2753 Art 6(1) Reg 473/2013 (emphasis added). This encompasses any and all recommendations issued under Regs 1466/97 (the MSP), 1467/97 (the EDP), 473/2011, encompassing CSRs and any Council or Commission recommendations; any and all recommendations issued in the context of the European Semester, including, but not limited to, economic policy recommendations under Reg 1176/2011; and any and all recommendations, and opinions issued under the EDP.
Such plans shall include, *inter alia*, a detailed breakdown of social spending, including education, healthcare and employment;\textsuperscript{2754} the targeted budget balance by sub-sector;\textsuperscript{2755} expenditure/revenue projections;\textsuperscript{2756} the measures necessary to reach the MTO;\textsuperscript{2757} the macroeconomic forecasts, methodologies, and models underpinning the budget;\textsuperscript{2758} and explanations on how the reforms address EU recommendations.\textsuperscript{2759}

The imperative ‘shall be consistent with’ has been interpreted as sufficiently clear and precise to constitute a binding obligation under EU law. The Commission has been under a legal obligation to ensure that ESM conditionality is ‘consistent with’ EU law since *Pringle v Ireland*,\textsuperscript{2760} and this was interpreted by AG Wahl in *Ledra v Commission and Council* as less than ‘obedience and full conformity’ between two texts, but something more than ‘compatibility and non-contradiction between them.’\textsuperscript{2761} In the Grand Chamber decision which followed, the ECJ held that the obligation to ensure that MoU’s are ‘consistent with EU law’ constituted a binding obligation on a decision-maker to ‘refrain from signing a memorandum of understanding whose consistency with EU law it doubts,’ and breach of that duty constituted an unlawful act for the purposes of EU non-contractual liability.\textsuperscript{2762}

The astute observer will no doubt contest that Article 6(1) of Reg 473/2013 is insufficiently clear and precise to ground an *ultra vires* challenge (against the regulation) where it concerns a Member State. If the Commission and Council recommend, for instance, that Italy establish vocational training schools (which they have),\textsuperscript{2763} but Italy instead chooses to spend its money on liberal arts, is that ‘inconsistent with’ the duty under Regulation 473/2013? It seems difficult to say. However it should be emphasised that the relative imprecision of ‘consistency’ does not matter to the conclusion that there is a binding secondary EU law threshold beyond which Member State legislation will no longer comply. Moreover, as will become apparent momentarily, the threshold will not always be ambiguous.

### 8.2.2.2 Component 2: Particularly Serious Non-Compliance

This is where the second component enters into the machinery. Under Article 7(1) of Reg 473/2013, if the Commission identifies ‘particularly serious non-compliance’ with the obligations under Article 6(1), the Commission (not the Council) will deliver an opinion to that effect and ‘request’ that the

\textsuperscript{2754} Art 6(3)(d) Reg 473/2013.
\textsuperscript{2755} Art 6(3)(a) Reg 473/2013.
\textsuperscript{2756} Art 6(3)(b) Reg 473/2013.
\textsuperscript{2757} Art 6(3)(c) Reg 473/2013.
\textsuperscript{2758} Art 6(3)(f),(g) Reg 473/2013.
\textsuperscript{2759} Art 6(3)(h) Reg 473/2013.
\textsuperscript{2760} *Pringle v Ireland* [163]-[164].
\textsuperscript{2761} *Ledra (Opinion of AG Wahl)* [72], interpreting the obligation under Reg 7 of 473/2013 to ensure that ESM MoU’s are ‘consistent with the measures of economic policy coordination provided in the TFEU.’
\textsuperscript{2762} Joined Cases C-8-10/15 *P Ledra* [58]-[60], [67].
\textsuperscript{2763} Council Recommendation of 8 July 2014 on the National Reform Programme of 2014 of Italy [2014] OJ C 247/11

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budget be re-drafted.\footnote{Art 7(2) Reg 473/2013 reads: ‘Notwithstanding paragraph 1, where, in exceptional cases, after consulting the Member State concerned within one week of submission of the draft budgetary plan, the Commission identifies \textit{particularly serious non-compliance} with the budgetary policy obligations laid down in the SGP, the Commission shall adopt its opinion within two weeks of submission of the draft budgetary plan. In its opinion, the Commission shall request that a revised draft budgetary plan be submitted as soon as possible and in any event within three weeks of the date of its opinion. The Commission's request shall be reasoned and shall be made public.’ (emphasis added).} This process will repeat until the budget is found compliant.\footnote{Art 7(2) Reg 473/2013} Recital 20 provides guidance on the definition of ‘particularly serious non-compliance.’ It states:

‘This will be the case, \textit{in particular}, where the implementation of the draft budgetary plan \textit{would put at risk the financial stability of the Member State concerned} or risk jeopardising the proper functioning of the [EMU] or where the implementation of the draft budgetary plan \textit{would entail an obvious significant violation of the recommendations adopted by the Council under the SGP}.’ (Emphasis added)

Three features of this definition are highlighted. First, this is not a closed list. The Commission has an open-ended discretion to find ‘particularly serious non-compliance’ based on factors not listed in Article 7 or Recital 20. Second, there is no cross-border element. Member States will be in particularly serious non-compliance where they put at risk the financial stability of their own country and no others. Third, the concept of ‘particularly serious non-compliance’ extends to ‘\textit{an obvious significant violation of the recommendations adopted by the Council}’ - it has nothing to do with the debt limits in the Treaty. It is perfectly likely that a Member State may be in ‘non-compliance’ for ignoring the preferred allocation of social, education, health and employment spending of the Union’s institutions.

Article 7(1), when read in isolation, is obviously non-binding. The opinion is not a binding instrument under Article 288 TFEU; there is no legal basis for an EU budgetary veto under Article 121 TFEU; and the ‘request’ is in the language of a non-binding invitation. Taking Article 7(1) in isolation, if the Member State elects to thumb its nose at the Opinion and stick with its original budget, it may do so.

However, Article 6(1) \textit{is} a binding legal obligation according to the ECJ.\footnote{Joined Cases C-8-10/15 \textit{P Ledra} [58]-[60], [67]; \textit{Ledra (Opinion of AG Wahl)} [72].} Read together, it would be surprising indeed if Reg 473/2013 could be interpreted in such a way that a national budget can both be ‘consistent with’ EU recommendations (for the purposes of Article 6(1)) and in ‘particularly serious non-compliance’ with those same EU recommendations (for the purposes of Article 7(2)). There is, therefore, a threshold for ‘consistency,’ and that threshold is a matter for the Commission to decide.

Because of this interaction, it is difficult, if not impossible, to read the two provisions in any way other than the following manner: If the Commission finds a national budget in ‘serious non-compliance’ under Article 7(2), the Member State is in breach of Article 6(1), and will be so until the
Commission approves the budget. Given that there is nothing in the legal basis of Article 121 TFEU to preclude Member States from being subject to infringement proceedings under Articles 258-260 TFEU, a negative Opinion under Article 7(1) appears to trigger a breach of Article 6(1), bringing the full supremacy of secondary EU law to bear on the fiscal sovereignty of the Member States.

8.2.2.3 Component 3: Particularly Serious Non-Compliant Budgetary Procedures

For the avoidance of doubt, the obvious defence against that charge is that Article 6(1) only binds the content of the draft budget - a document or set of documents sat on a table at EU level. It does not bind the executive or the legislature in so far as the real budget may legislate for a different outcome altogether.

Here Articles 3 and 4(1) of Reg 473/2013 introduce a final component to this machinery. Those articles do not bind a document or set of documents at EU level. They bind the entirety of the ‘Member States budgetary procedure’ and ‘medium-term fiscal plans produced in accordance with their medium-term budgetary framework.’ As defined in Articles 2(1)(c) of Reg 473/2013 and 2(e) of Directive 2011/85/EU, this encapsulates the budgetary framework in its entirety, including the setting of policy priorities, the MTO, and the enforcement of numerical fiscal rules required under Directive 2011/85/EU and Reg 473/2013.

This closes the circle. If the budgetary executive is able to persist in tabling a budget which is in ‘particularly serious non-compliance’ with EU recommendations in December, despite having twice already failed to internalise the obligations under Article 4(1) (in April) and Article 6(1) (in October), they can hardly be said to have a budgetary procedure which is ‘consistent with’ those recommendations for the purposes of Article 3 and 4(1) of Reg 473/2013.

Italy’s 2014 MTO and budgetary process is instructive. In April 2014, Italy’s fiscal plans calculated the appropriate MTO adjustment path to be 0.5% of GDP, but instead pursued a lesser adjustment of 0.2%, amounting to a total deviation of 0.3% of GDP. Under Article 5(2) of Reg 1466/97, the Commission/Council calculated the appropriate path to be 0.7% of GDP, and estimated Italy’s

2767 Art 3 Reg 473/2013 states: ‘The Member States’ budgetary procedure shall be consistent with: (1) The framework for economic policy coordination in the context of the annual cycle of surveillance, which includes, in particular, the general guidance to Member States issued by the Commission and the European Council at the beginning of the cycle; (2) the recommendations issued in the context of the SGP; (3) where appropriate, recommendations issued in the context of the annual cycle of surveillance, including the macroeconomic imbalances procedure; and where appropriate opinions on economic partnership programmes.’

2768 Art 4(1) Reg 473/2013 states: ‘Such plans shall be consistent with the framework for economic policy coordination in the context of the annual cycle of surveillance, which includes, in particular, the general guidance to Member States issued by the Commission and the European Council at the beginning of the cycle […] the recommendations issued in the context of the SGP and, where appropriate, with recommendations issued in the context of the annual cycle of surveillance, including the macroeconomic imbalances procedure, and opinions on economic partnership programmes.’

2769 Art 2(1) Directive 2011/85/EU, as incorporated by Art 2(1)(c) Reg 473/2013 states: ‘medium-term budgetary frameworks [are] a specific set of national budgetary procedures that extend the horizon for fiscal policy-making beyond the annual; budgetary calendar, including the setting of policy priorities and of medium-term budgetary objectives.’

2770 Italy: Stability Programme 2014 (2014), 25, 38, as required under Article 4(1) Reg 473/2013
planned adjustment to amount to 0.1% - a deviation of 0.6% of GDP.\footnote{\textsuperscript{2771}} This is important, since a deviation of 0.5% of GDP is a ‘significant deviation’ for the purposes of the EDP,\footnote{\textsuperscript{2772}} and is not ‘consistent with’ the recommended MTO under Article 4(1) of Reg 473/2013.\footnote{\textsuperscript{2773}}

Under Article 6(1), Italy should then be required to submit a draft budgetary plan which would be ‘consistent’ with that recommendation. It did not do this, and in November 2014 the Commission Opinion stated that Italy’s draft budget was ‘at risk of non-compliance.’\footnote{\textsuperscript{2774}} This opinion, too, should be internalised into Italy’s budgetary procedure according to Article 3 Reg 473/2013.

Once again, of course, Italy did not comply. The budget ultimately legislated for a deterioration of -0.5% of GDP, as opposed to the required adjustment of +0.1% - precisely the deviation of 0.6% of GDP which the Commission had stated in July to be a significant observed deviation.\footnote{\textsuperscript{2775}}

Could Italy’s budgetary procedure be said to be ‘consistent with’ the Commission’s recommendations and opinions as required under Article 3 Reg 473/2013? Surely not. A Member State which is able to ignore the requirement to submit a consistent fiscal plan in April,\footnote{\textsuperscript{2776}} ignore the requirement to submit a consistent draft budget in October,\footnote{\textsuperscript{2777}} and then proceed to enact a budget that is in ‘serous non-compliance,’\footnote{\textsuperscript{2778}} can hardly be said to have a budgetary procedure which is ‘consistent with’ those recommendations for the purposes of Article 3 Reg 473/2013.

For obvious constitutional and political reasons the Commission did not, of course, issue a negative opinion. In practice, this Opinion has been threatened widely, but never used.\footnote{\textsuperscript{2779}} As the Financial Times remarks:

‘The chance of Brussels actually rejecting the Italian budget remains small, as the step would be explosive, and unprecedented. It would also probably end up doing more damage to the waning support for the euro in Italy … kicking of the madre e padre of all clashes with Rome.’\footnote{\textsuperscript{2780}}

\footnote{\textsuperscript{2771}} Council Recommendation of 8 July 2014 on the NRP of Italy, 58-59. Art 5(2) states: ‘Where the Council, in accordance with Article 121 TFEU, considers that the objectives and the content of the programme should be strengthened with particular reference to the adjustment path towards the medium-term budgetary objective, the Council shall in its opinion invite the Member State concerned to adjust its programme.’


\footnote{\textsuperscript{2774}} Commission Opinion of 28 November 2014 on the Draft Budgetary Plan of Italy, para 12.


\footnote{\textsuperscript{2776}} Art 4(1) Reg 473/2013.

\footnote{\textsuperscript{2777}} Art 6(1) Reg 473/2013.

\footnote{\textsuperscript{2778}} Art 7(2) Reg 473/2013.

\footnote{\textsuperscript{2779}} Politi and Brunsden (2014): a decision to adopt a negative opinion on Italy’s budget ‘would be an unprecedented step.’

Nevertheless, this does not affect the conclusion that, as a matter of law, Italy’s fiscal plans (Article 4), draft budget (Article 6) and budgetary procedure (Article 3), were in breach of directly applicable secondary EU law under Reg 473/2013, and the button on this machinery remains in place, should it ever be pressed. This remains important even when it is not employed. As shown in February 2016 when the newly-elected 2016 Portuguese government was forced to make an 11th hour, €135m cut to its 2016 budget, negotiations under the threat of the Commission’s Article 7(1) veto are conducted behind closed doors, they are subject to no judicial or legislative scrutiny, and they result in far-reaching changes to national budgets. 2781

8.2.2.4 Assessment: A Budgetary Veto with an Inadequate Legal Basis

Neither the recommendations or opinions adopted under Articles 121(2),(4) or 126(3),(5),(7) and (9) TFEU derive from a legal basis to adopt binding legislation. 2782 Their purpose is to give substance to the monitoring and coordination procedures at EU level, which are themselves non-binding. 2783 Absent some incorporation into binding EU law, even a clear, unconditional, sufficiently certain and unequivocal obligation, with no discretion as to the result to be achieved, will not be capable of legal effect under Article 288 TFEU. 2784 From the harmless safety of this ‘coordination’ competence, the EU regularly issues recommendations and opinions which run the full gamut of economic and social policy from ‘improving work-life balance’ to ‘reducing the high tax wedge on labour’. 2785

However, a non-binding recommendation can be imbued with legal force through incorporation into binding EU law. In Germany, France, the Netherlands, Denmark and the UK v Commission, for example, the ECJ held that the EU’s ‘coordination’ competence in social policy would not encroach on Member States’ exclusive social policy powers only in so far as they are not covered by other provisions of EU law. 2786 Similarly, in Grimaldi, the ECJ interpreted the effect of a recommendation as follows:

‘[I]t must be stressed that the measures in question cannot be regarded as having no legal effect. The national courts are bound to take recommendations into consideration in order to decide disputes submitted to them, in particular where they case light on the interpretation of national measures adopted in order to implement them or where they are designed to

2781 Peter Spiegel, Peter Wise, ‘Portuguese budget avoids rejection by Brussels’ Financial Times (5 February 2016).
2782 Art 288(5) TFEU states: ‘Recommendations and opinions shall have no binding force.’ See, also, Case C-322/88 Grimaldi v Fonds des Maladies Professionnelles [1989] ECR 4407 [13]: they are adopted by the Union when they do not have the power under the Treaty to adopt binding EU law, or when they consider that mandatory law is not appropriate.
2783 As shown in Section 2.3.2, the MSP under Article 121 TFEU and the EDP under Article 126 TFEU are multilateral political mechanism that contains no provisions for binding EU law. Article 126(10) TFEU states clearly that Member States cannot be subject to infringement proceedings for failing to adhere to 3% deficit and 60% debt rules.
2784 The ECJ will look behind the form of the measure to determine whether this is so: Grimaldi [14]; Kotnik (Opinion of AG Wahl) [38]-[39] and Kotnik (Opinion of AG Wahl) [44].
supplement binding Community provisions. … in particular where they are capable of casing light on the interpretation of other provisions of national or Community law.”

Herein the problem lies. In principle, a failure to adopt the ‘recommended’ outcome will lead to a breach of Articles 3, 4(1) and 6(1) of Reg 473/2013 which, under Article 288 TFEU, are binding in their entirety and directly applicable in all Member States. This gives the Union a ‘quasi-legislative’ competence to set economic, social and budgetary policies under the non-binding instruments of Articles 121 and 126 TFEU and then imbue them with binding force by vetoing policies which are inconsistent with those instruments.

8.2.3 Conclusion: Two Manifest Infringements of Member State Fiscal Sovereignty

Under Articles 3, 4(1), 4(4), 5(1), (2), 6(1) and 7(1) of Regulation 473/2013 of the ‘two pack’, and Articles 4, 5, 6 and 10 of Directive 2011/85/EU of the ‘six pack,’ elected budgetary executives are bound at each stage of the decision-making process:

[8.2.1.1] First, elected budgetary executives and legislatures are legally bound, as a matter of EU law, to base the budgetary framework and budgetary legislation upon the macrofiscal assessments of ‘independent bodies’ which are [8.2.1.2] mandated by EU law under Directive 2011/85/EU and Reg 473/2013, supervised by the Commission, and legally required to replicate EU technical assessments for specific purposes. 2788 [8.2.1.3] Ex-post, under Articles 5 of Directive 2011/85/EU, 3 of Reg 473/2013 and 3 of the TSCG, Member States are then required to legislate national fiscal rules to enforce compliance with the MTO and EU debt rules; and under Articles 6(1)(b) of Directive 2011/85/EU and 5(2)(a) of Reg 473/2013, these are to be monitored and triggered by ‘independent bodies’ on the basis of the Commission’s assessments of a ‘significant observed deviation’ under Article 6(2) of Reg 1466/97. [8.2.1.4] According to the ECJ’s case law, it is impossible to avoid the conclusion, a fortiori, that the technical assessments which bind elected budgetary executives in this section are acts of EU law. 2789

[8.2.2] Second, the Commission is then given trigger for a legal mechanism – the ‘budgetary veto’ - that binds budgetary policies directly, such that failure to internalise or secure the legislated-for substantive outcome at EU level will lead to a breach of EU law itself. Under Article 7(1) of Reg 473/2013, the Commission may declare the budget in ‘particularly serious non-compliance’, even if this only concerns specific substantive economic policy choices, and even where there are no spillovers to the union. This signals that the ‘particularly serious non-compliant’ budget is not ‘consistent with’ Articles 3, 4(1) or 6(1), triggering a binding EU law obligation.

2787 Grimaldi [18]-[19].
2788 Art 5(2)(a) of Reg 473/2013, for example, states that the ‘independent bodies’ shall assess the need to activate the correction mechanism under the Fiscal Compact ‘in accordance with Art 6(2) [Reg 1466/97]’ - the assessment of a ‘significant observed deviation’ by the Commission.
2789 James Elliott Construction v Irish Asphalt.
Herein the problem lies. It must be recalled that the legal basis for this entire apparatus - Regulations 1466/97 and 473/2013, in conjunction with Directive 2011/85/EU – is Article 121(6) TFEU. Under that article, the Council is empowered to adopt regulations setting out detailed rules for two stages of the MSP: Commission monitoring under Article 121(3) TFEU and Council recommendations under Article 121(4) TFEU. But those articles are not legally binding either: Article 121(3) empowers the Commission to monitor economic policies, and Article 121(4) empowers the Council to make non-binding recommendations. Regulation 473/2013 cannot amend the scope of Articles 121(3) and (4), and so cannot prescribe budgetary outcomes in national law.

And yet, as has just been shown, these mechanisms do, in fact, bind the entire budgetary enactment process. This is certainly how it is interpreted by the Member States. Ireland’s Medium-Term Budgetary Framework (as required by Reg 473/2013), for example, states:

‘It is important to note that these are fiscal rules with which Ireland must comply, whether they arise as a result of EU legislation which has been given effect through Irish legislation or EU legislation with direct effect. […] The SGP and Fiscal Compact obligations set out above must be complied with in every one of the processes and outputs of our fiscal planning process, and in the implementation of the annual budget.’

In that regard, as shown in Chapter 1, Section 1.3.1, the litmus test for Member State fiscal sovereignty is the German constitutional identity jurisdiction under Articles 38, and 20, in conjunction with Article 79(3) BL. The test set out in Sections 1.3.1.3-1.3.1.6 of this thesis for evaluating whether a fetter on budgetary autonomy amounts to a deprivation of the right to vote is whether control over that policy is relinquished, such that the fetter is irreversible by an equivalent act of the Bundestag in the future. What is guaranteed is a specific right to take part in the exercise of state budgetary power (20(2) BL) according to a specific formula – that is, by voting (38(2)) in general, direct, free, secret, and equal elections (meaning one person one vote) (38(1)(i)) of a specific institution: an autonomous parliament free of other-directedness (38(1)(ii) BL) which possesses the substance of the power to rule (20(2) and 79(3) BL). In Aid measures for Greece (Germany), and Re ESM (Germany), the court held:

‘A necessary condition for the safeguarding of political latitude in the sense of the core of identity of the constitution (art.20(1) and (2), art.79(3) BL) is that the budget legislature makes its decisions on revenue and expenditure free of other-directedness on the part of the bodies

2790 Those articles allow the Council to monitor and address warnings to Member States where economic policies either ‘risk jeopardising the proper functioning of the EMU’ (121(3)) or are not consistent with the BEPGs (121(4)).

2791 NB: The order of these statements has been changed of ease of understanding. The latter sentence precedes the formed in the original source. Department of Finance, Medium-Term Budgetary Framework (Republic of Ireland, 2014).

2792 Aid Measures for Greece (Germany) [124], [127]; Re ESM II (Germany) [168]-[170].

2793 Re ESM II (Germany) [224], [230]; Aid Measures for Greece (Germany) [98], [120].

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and of other Member States of the European Union and remains permanently “the master of its decisions.”

It is clear that this framework does not meet this test. The framework above grips each stage of the decision-making process for the drafting of a budget; it is not optional; the budgetary executive is not accountable to the constitutional parliament in the development of its macrofiscal policies; and, as binding secondary EU law, it cannot be reversed by an equivalent action of the Bundestag in the future. It grips each link in the ‘chain of legitimisation’ in a manner that violates the test set out by the German Constitutional Court. If these instruments are to provide a beneficial role in European federalism, Articles 6(1) and 7(1) must be amended so that they are extracted from each other – such that the Opinion in 7(1) does not trigger the rule in 6(1); and Articles 4(1) of Directive 2011/85/EU and 4(4) of Regulation 473/2013 must be amended so that the macrofiscal assessments of ‘independent’ fiscal bodies do not bind budgetary executives under secondary EU law. Unless and until those articles are dis-entwined, these machineries cannot be effective, and in so far as they prove effective, then vulnerable to repudiation by Member State constitutional courts.

8.3 Binding Vertical Interlinkages with EU Fiscal Governance

The second architecture of concern to this chapter is a web of secondary EU legislation which vertically integrates the EU’s fiscal governance procedures into member State constitutional orders.

The main substantive output wielded in this section is the Medium-Term Objective and the adjustment path towards it. The MTO was introduced in 2005 under the OMC to provide additional flexibility with regards to the budgetary objective of ‘close to balance or in surplus.’

Under the new regime, once established, the MTO now takes on precedence as the main norm for all Member State budgetary policies due to various amendments to national fiscal rules under both EU and national law. At EU level, the MTO is established, monitored and enforced under a reinforced ‘hard law’ MSP, complete with its own sanctioning mechanism under a reverse-QMV procedure.

At Member State level, under secondary EU legislation, the MTO becomes the overarching objective of the entire national budgetary process under Directive 2011/85/EU and Reg 473/2013, and a legal stipulation for all subsequently-enacted budgetary legislation (under Articles 3(1)(b) TSCG and 3, 4(1) and 6(1) of Reg 473/2013) that is, in principle, enforced by EU-legislated fiscal councils under 5(2)(a) of Reg 473/2013. In short, as Chalmers observes, the MTO is now the norm ‘which

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2794 Re ESM I (Germany) [197]. See also: Re ESM II (Germany) [164]; Aid Measures for Greece (Germany) [127].
2796 The MSP provides for the establishment of a country-specific MTO (Arts 2a and 5 of Reg 1466/97); Commission warnings of ‘significant observed deviations’ under Article 121(4) TFEU; and sanctions under Arts 6(2), 9(2) Reg 1466/97.
2798 See above, Section 8.2.1.3.
moves States into a regime where their budgetary planning is co-governed by the EU institutions.\footnote{2799}

This section identifies three mechanisms which vertically integrate substantive EU fiscal policies into Member State constitutional orders:

[8.3.1] The analysis begins by examining the question of where the MTO comes from: That is, whether Member States are legally free, as a matter of EU law, to legislate their own MTOs. It finds that, as a result of Articles 3, 4(1) and 6(1) of Reg 473/2013, it is the value produced by the Commission and the Council under Articles 5(1) and 9(1) Reg 1466/97 – not the assessment of the Member State - which defines the appropriate MTO and adjustment path towards it for the purposes of Directive 2011/85/EU;\footnote{2800} budgetary processes, fiscal plans (SCPs) and draft budgets under Reg 473/2013;\footnote{2801} and fiscal rules under Articles 3(1)(b) TSCG and 5(2)(a) of Reg 473/2013.\footnote{2802} The MTO is legislated by the Union.

[8.3.2] Second, Article 3 of the TSCG requires EMU countries to entrench the MTO in national law 'through provisions of binding force and permanent character, preferably constitutional,' so that the EU-defined MTO and assessments are, in principle, binding on the budgetary process.\footnote{2803} This is not an instrument of EU law. However, Regulation 473/2013 states that the correction mechanism must be triggered automatically by an ‘independent’ fiscal council, implanted there by EU law, on the basis of the Commission’s declaration of a ‘significant observed deviation.’\footnote{2804} This spans the boundary between legal orders and co-opts the Fiscal Compact, inserting the Commission’s determination under Article 6(2) Reg 1466/97 into an intergovernmental Treaty that binds Member State constitutional law.

[8.3.3] Third, Directive 2011/85/EU requires Member States to enact numerical rules which ‘effectively promote compliance’ with the 3% deficit limit, the 60% debt limit and to the MTO, and annual budget legislation must be consistent with the numerical rules in force.\footnote{2805} Article 2a of Reg 1466/97 then adds that ‘respect of the [MTO] shall be included in the national medium-term budgetary frameworks in accordance with [Directive 2011/85/EU].’ This appears to switch the obligation under Directive 2011/85/EU from ‘promote compliance’ to ‘shall respect,’ which is capable of binding Member States as to the result to be achieved under Article 288 TFEU according to the established interpretations of the ECJ. This would appear, in a similar vein to the preceding three mechanisms examined in this chapter, to bind elected budgetary executives in their exclusive economic competences.

\footnotesize
\begin{itemize}
\item \footnote{2799}{Chalmers (2012), 679.}
\item \footnote{2800}{Arts 4-5, 9-14 Directive 2011/85/EU.}
\item \footnote{2801}{Arts 4, 4(1) and 6(1) Reg 473/2013.}
\item \footnote{2802}{See below, Section 8.3.2.}
\item \footnote{2803}{Art 3 TSCG.}
\item \footnote{2804}{Art 6(2) of Reg 1466/97.}
\item \footnote{2805}{Arts 5, 9-10 Directive 2011/85/EU.}
\end{itemize}
[8.3.4] Fourth, the analysis examines the effect of new sanctions and reverse-QMV voting under both limbs of the governance framework under Articles 121 and 126 TFEU. As will be shown, the effect of the new framework is that that, while the Commission has no competence in economic policy and the recommendations are not legally binding stricto sensu, under Articles 2-a(3) (CSRs), 6(2) of Reg 1466/97 and Regs 1173-1174/2011, the Commission is, ‘as a rule’, presumed to be able enumerate a detailed list of economic policy measures and then sanction Member States who do not comply under reverse-QMV. 2806 Not only is the Council ‘expected to, as a rule’ follow the Commission recommendations, but fines are adopted automatically unless the Council votes to reject the recommendations. As will be shown, RQMV is defined in accordance with Article 238(3)(b) TFEU, requiring 72% of the Member States comprising 65% of the population, 2807 which means that abstentions effectively count as ‘yes’ votes. This lowers required positive votes of support to zero. 2808 The effect of this is that the Commission can pass legislation in the face of an overwhelming population majority of up to 93.61% 2809 or numerical majority of fifteen countries, 2810 with zero votes of support. Section 8.3.4 examines whether this amounts to a violation of the boundaries in this thesis.

This section concludes that the mechanisms in Section 8.3.2 and 8.3.3, in conjunction with the MTO under 8.3.1, entail an ultra vires infringement of national fiscal sovereignty and constitutional identity according to the opinion of the European Legal Service and three Member State ‘constitutional identity’ rulings, Re ESM II (Germany), TSCG (France), and TSCG (Austria). In order for the legal framework of the TSCG and Regulation 1466/97 to be reconcilable with the European legal order, Article 5(2)(a) of Regulation 473/2013 must be amended so as to withdraw the insertion of the Commission trigger from the TSCG framework, and Article 2a must be softened so that it no longer binds Member States to the EU MTO. Unless and until this is done, this section concludes that this constitutes a serious trespass of the European legal order threatening the integrity of the framework as a whole. The mechanism in Section 8.3.4 does not infringe the boundaries in this thesis.

2806 De Stree (2014), 92.
2807 Art 12(2) Reg 1173/2011; 5(2) Reg 1174/2011; Art 7 TSCG.
2808 For this point, see: Van Aken and Artige (2013).
2809 This scenario imagines a proposal to sanction Portugal or Greece in a vote in which Austria, Belgium, France, Germany, Greece, Ireland, Italy, the Netherlands and Spain (93.51% of the population) are opposed, and Cyprus, Estonia, Finland, Latvia, Lithuania, Luxembourg, Slovakia, Slovenia and Malta (6.39% of the population) abstaining.
2810 This assumes that the decision is a decision on sanctions or recommendations and therefore the state subject to the motion does not participate. The numerical majority can climb to 16 if it concerns the decision finding an excessive deficit. In this scenario, Austria, Belgium, Cyprus, Estonia, Finland, France, Ireland, Latvia, Lithuania, Luxembourg, the Netherlands, Portugal, Greece, Slovakia, and Slovenia are opposed. In a vote where either Portugal or Greece are abstained, Germany (24.7% of the population) could apply sanctions if it abstains with any one of France (20.2%), Spain (14.1%) or Italy (18.7%). France can do the same if Germany or Italy abstain.
8.3.1 The Multilateral Surveillance Procedure and the MTO

Since the MTO takes on such alleged legal force, it is vital to begin the analysis with a discussion of where it comes from. If Union institutions were to legislate a numerical value which bound national executives as the overarching precondition of budgetary competence, this would raise the prospect of a severe *ultra vires* breach going to the core of budgetary sovereignty. However, a numerical value unilaterally incorporated by Member States of their own volition would not. This section examines whether Member States are legally free, as a matter of EU law, to legislate their own budgetary objective.

8.3.1.1 Member States ‘Present’ the MTO

The legal basis of the MTO is an instrument of EU law: Article 2a of Reg 1466/97 states that ‘Each member State shall have a differentiated MTO … within a defined range between -1.0% of GDP and balance or surplus.’2811 The basic definition of the MTO therefore remains unchanged from 2005.2812 However, two features of this article are of note:

First, not any budgetary objective will do. A Member State could only set ‘the alleviation of poverty’ as its primary budgetary objective in so far as this is does not result in an MTO outside the defined range of -1% of GDP. To the extent the EU legislation examined below creates binding interlinkages with this variable, it will *prima facie* bind Member States in their exclusive budgetary competence.

Second, nowhere in Regulation 1466/97 does it state where the MTO comes from. Article 2a states that each Member State ‘shall have’ an MTO, but it does not state who is responsible for the definitive calculation. It is a curious case of what Dawson calls ‘rolling’ legal enforcement, where each Member State ‘shall have’ a thing to implement, but legal accountability for that thing is not attributable to either Member States or EU institutions.2813

Yet determining who is responsible for the authoritative calculation is vital. This is so because the MTO depends on various factors such the output gap, the economic cycle, and the value of structural reforms, for which – as the Commission admits - forecasting errors and differences of opinion are an ‘inevitability.’2814 The IMF notes that the EU, the IMF and the OECD all use standard methodologies

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2811 Art 2a Reg 1466/97 states: ‘Each Member State shall have a differentiated medium-term objective for its budgetary position. These country-specific medium-term budgetary objectives may diverge from the requirement of a close to balance or in surplus position, while providing a safety margin with respect to the 3 % of GDP government deficit ratio. The medium-term budgetary objectives shall ensure the sustainability of public finances or a rapid progress towards such sustainability while allowing room for budgetary manoeuvre, considering in particular the need for public investment. Taking these factors into account … budgetary objectives shall be specified within a defined range between -1 % of GDP and balance or surplus, in cyclically adjusted terms, net of one-off and temporary measures.’ Arts 5 and 9 Reg 1466/97 then prescribe a litany of factors for evaluation of the MTOs by the Commission and Council. The appropriate MTO adjustment path in cyclically-adjusted terms is interpreted by a matrix set out in Annex 2 of a Commission interpretive communication: Commission, ‘Making the Best Use of the Flexibility within the SGP’ COM(2015) 12 final, Annex 2.

2812 See: Section 3.3.4.


for potential GDP in Ireland, for example, ‘yet produce significantly different estimates.’

Determining who has the ‘final word’ on the calculation of the MTO is paramount because, once determined, it is not only sanctioned at EU level but, as will be alleged, takes on legal effects in national law.

The first possibility is that the MTO is legislated by the Member States. There are two pieces of evidence for this: The methodology for the MTO is set out in a Code of Conduct issued by the Council, but it is not legally binding; and the first chronological appearance of the MTO in the European Semester is in Article 3(2)(a) of Reg 1466/97, which states that Member States ‘shall present’ their MTO as part of their SCPs submitted in April 20th each year.

A closer look reveals otherwise, however. First, as shown in Section 8.2.2, under Article 4(1) of Directive 2011/85/EU, in combination with Articles 4(4) and 2(1)(a) and (b) of Reg 473/2014, budgetary executives are legally required by EU law to establish their MTO on the most likely scenario, compared against the Commission’s forecasts, and calculated or endorsed by ‘independent’ fiscal institutions which are, as shown in Section 8.2.1.2, legally, functionally and comprehensively governed by the Commission.

Second, Member States are not legally free to choose the MTO ‘presented’ in their SCPs, even if they somehow make it through the entire framework set out in Section 8.2.1 to arrive at their own calculation. It must be recalled that, under Articles 3, 4(1) and 6(1) of Reg 473/2013, Member State budgetary frameworks, draft budgetary plans, and medium-term fiscal plans and SCPs must be ‘consistent with,’ inter alia, any and all recommendations issued under Regulations 1466/97, 1467/97, 1176/2011, and 473/2013; and the Opinion on the EPP. This includes the MTO. The Commission Vade mecum on the SGP, for example, states that ‘compliance of the Member State’s policies’ is assessed against the ‘previous year’s country-specific recommendation … in terms of the requirements to attain or be on the adjustment path towards the MTO.’

This creates a sort of circular legal duty: Member States may ‘present’ their own MTO’s under Article 2a Reg 1466/97, but only if these MTOs are ‘consistent’ with those of the Commission and

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2817 Arts 5, 9-10 Directive 2011/85/EU; Art 3(1b) and (1d) TSGC; Art 5(2)(a) Reg 473/2013.
2819 Art 2a Reg 1466/97 as amended by Art 1(5) Reg 1175/2011, in combination with Articles 3(2) and 7(2) of Reg 1466/97 and 4 of Reg 473/2013.
2820 On this framework and recitations of these provisions see: Sections 8.2.1-8.2.2.
2821 See infra, Section 8.2.1.1. Art 4(4) Reg 473/2013 states: ‘National medium-term fiscal plans and draft budgets referred to in paragraphs 1 and 2 shall be based on independent macroeconomic forecasts, and shall indicate whether the budgetary forecasts have been produced or endorsed by an independent body.’
Council. Otherwise, they will be in breach of secondary EU law under Reg 473/2013 (discussed above).  

8.3.1.2 Member States are Bound to the MTO Established by the Commission and Council

Once the MTO is ‘presented,’ it is for the Council and Commission, under Arts 5(1) and 9(1) Reg 1466/97, to assess whether the economic assumptions underpinning the MTO are plausible, whether the annual adjustment path is appropriate, and whether the proposed economic policies are sufficient to achieve the MTO over the cycle. It is at this stage the appropriate MTO and adjustment path towards it is defined for the instruments described below - not by the Member State, but by the Commission and the Council under Articles 5(1) and 9(1) of Reg 1466/97. The formula for ‘defining the appropriate adjustment path to the medium-term budgetary objective’ is clearly addressed to those institutions. An appropriate MTO adjustment path is determined by the Commission, as follows:

First, the Commission assesses the appropriate MTO adjustment path (the ‘appropriate annual improvement of its cyclically-adjusted budget balance, net of one-off and other temporary measures’), as well as the expenditure benchmark required to meet the MTO, using an annual adjustment of 0.5% of GDP as a benchmark.

Second, to cyclically-adjust the appropriate MTO, the Commission has set out a classification matrix which estimates the required adjustment against the output gap (a proxy for the economic cycle) and gross debt. The matrix sets out five categories ranging from ‘good times’ (a positive output gap of ≥1.5%) to ‘exceptionally bad times’ (a negative output gap of ≥4%). On this matrix, where Article 5 of Reg 1466/97 uses 0.5% of GDP as a benchmark, the Commission interprets this path (or higher) as being appropriate only for Member States with an output gap of better than -1.5% of GDP. Member States in ‘bad times’ (a 1.5-3% negative output gap), ‘very bad times’ (a 3-4% negative output gap), or ‘exceptionally bad times’ (a negative output gap of >4% or negative GDP growth), the required adjustment will always

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2824 See infra, Section 8.2.2, in particular Section 8.2.2.3 at p 223.
2825 The Commission will assess whether the MTO is ‘appropriate’ by determining whether the MTO is in line with the minimum MTO’s emerging from the commission’s application of the formula. If not, under Articles 121(3) TFEU and Arts 5(2) and 9(2) of Reg 1466/07, the Member State will be invited to adjust its programme.
2826 The Commission will then assess whether the Member State is on its adjustment balance, by determining whether the Member State will have a structural balance at least as tight as its MTO for the in-year and ex-ante assessments. European Commission, 'Vade mecum' (2013), 26-27; Arts 5, 9 Reg 1466/97 (as amended).
2827 None of the articles setting out the calculation of the MTO are addressed to the Member States. See: Arts 2a, 3(2)(a). 5(1) and 9(1) Reg 1466/97.
2828 For Member States with debt over 60% of GDP, or with pronounced risks of overall debt sustainability, a faster adjustment path over 0.5% of GDP is expected: European Commission, 'Vade mecum' (2013); European Commission, 'Making the Best Use of the Flexibility within the SGP’ COM(2015) 12 final, Annex 2.
2830 Member States in ‘normal times’ (defined an output gap of -1.5 to +1.5% of GDP), and ‘good times’ (an output gap of over +1.5%) are required to achieve an a .5% adjustment, or higher if debt is above 60% or growth is above potential.
be zero (for countries with debt below 60%), or below 0.25% (for countries with debt above 60% of GDP).

If the Commission and Council assess that the MTO adjustment path is inadequate, it ‘shall’ invite the Member State concerned to adjust its programme, and the appropriate MTO adjustment path will be included in the country-specific recommendations (CSRs) issued for each Member State in May. Once again, under Reg 473/2013, national budgetary frameworks, SPCs, and draft budgets must be consistent with these recommendations or they will be ‘particularly serious non-compliance’ by November 30th.

Whether or whether not the Member State agrees, it is the statistical value determined in those articles – Articles 5(1) and 9(1) of Reg 1466/97 - which takes on legal force for countries which are not at their MTO under the terms of the TSCG, Directive 2011/85/EU, and Reg 473/2013. This is stated explicitly throughout the governance framework and the interpretive instruments surrounding it. This is stated in Article 3(1)(b) TSCG, which enforces the MTO adjustment path ‘as defined in the Stability and Growth Pact’ (i.e. Articles 5(1) and 9(1) of Reg 1466/97); and it is stated in Article 5(2)(a) Reg 473/2013, which defines cases of significant observed deviation ‘in accordance with Article 6(2) of Reg 1466/97’ (which empowers the Commission to make that determination against the MTO in Article 5(1) of Reg 1466/97). Similarly, the purpose of Directive 2011/85/EU is ‘to ensure the achievement of the medium-term objectives set at EU level,’ and the purpose of Reg 473/2013 is to enforce the medium-term budgetary objectives ‘set at Union level’.

This is also how it is interpreted by EU and Member State institutions. According to the Commission, it is for the Union to establish the MTO, and Member State can then comply ‘by adopting either an MTO in line with these lower bounds or a more ambitious one.’ Ireland’s Medium-Term Budgetary Framework states that the MTO is ‘subject to a minimum set by the EU Commission.’ A Member States who finds that the Commission’s formula lead to an

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2831 Arts 5(2), 9(2) Reg 1466/97 (as amended).
2832 Art 3(1) Reg 473/2011.
2834 Art 6(1) Reg 473/2011.
2835 See: Section 8.3.2. Art 3(1)(b) TSCG states: ‘the rule under point (a) shall be deemed to be respected if the annual structural balance of the general government is at its country-specific medium-term objective, as defined in the revised Stability and Growth Pact… Progress towards, and respect of, the medium-term objective shall be evaluated on the basis of an overall assessment with the structural balance as a reference, including an analysis of expenditure net of discretionary revenue measures, in line with the revised Stability and Growth Pact’
2836 Arts 4-5 Directive 2011/85/EU referring (at 5(b)) to ‘adherence to the Member State’s medium-term objective.’
2837 Arts 3, 4(1), 6(1) Reg 473/2013, examined in Section 8.2.2.
2841 Ireland,Medium-Term Budgetary Framework (2014), 50 (emphasis added).
‘unrealistically tight primary balance’, must ‘ask to benefit from an exception clause.’ The budgetary executive cannot simply choose their own.

8.3.1.3 Significant Observed Deviation and the Commission Warning

Finally, in order to operationalise the MTO and imbue it with coercive force, the ‘six-pack’ introduced the concept of a ‘significant observed deviation’ from the MTO or the adjustment path towards it. A significant observed deviation will occur the Commission finds that is a deviation from the adjustment path of at least 0.5% of GDP in one year, or 0.25% of GDP in two consecutive years and an excess of expenditure growth with a negative impact on the government balance of 0.5% of GDP over 1-2 years or if one of these criteria is met but there is limited compliance with the other. Thus, once the MTO has been assessed under Articles 5(1) and 9(1) of Reg 1466/97, the Commission will monitor the implementation of stability programmes with a view to identifying actual or expected (ex-ante) significant deviations from the MTO adjustment path. In the event of a deviation, the Commission shall now issue an autonomous warning to the Member State under Article 121(4) TFEU (previously this was issued by the Council).

At EU level, this triggers the newly-added sanctioning mechanism of the MSP, which may result in (a) more specific recommendations specifying the measures required therefore; (b) ‘enhanced surveillance’, under which the Commission (in conjunction with the ECB) is authorised to undertake on-site, IMF-style surveillance missions; and (c) ‘no effective action’ and sanctions, according to the procedure summarised above in Section 8.1. At Member State level, the Commission warning is linked to different punitive effects under rules legislated into national budgetary frameworks by

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2842 European Commission, 'Vade mecum' (2013), 17, 20 states that ‘the function of the [Member State] SCPs is to allow the Commission and the Council to assess compliance with the MTO and the adjustment path’ - not to establish it.

2843 Arts 6(2)-(3) and 10(2)-(3) of Reg 1466/97; European Commission, ‘Specifications of the Council of 3 September 2012 on the SGP’ (2012), 7. This is sanctionable with a deposit of 0.2% of GDP: Art 4, 1173/2011. Deviations shall not be considered significant if the Member States has overachieved the MTO, taking into account the possibility of significant revenue windfalls (provided that it does not jeopardise the programme objective), or when it results from an unusual event ‘outside the control of the Member State’, (provided that this does not endanger medium-term fiscal sustainability). See also; Commission, 'Vade mecum' (2013), 38.

2844 Arts 6(1), 9(1) Reg 1466/97, under Article 121(3) TFEU. The ex-ante assessment is based on the year that is underway and the following three years. It aims to deliver an overall assessment about whether (i) the MTO is appropriate; (ii) the Member State is at the MTO or on the adjustment path; and (iii) whether it complies with the expenditure benchmark. The ex-post assessment is of the implementation of the SCPs, and centers on whether there have been significant observed deviations from the MTO or the adjustment path towards it in the preceding year or the past two years. It is this assessment which may lead to a warning under Art 121(4) TFEU. European Commission, 'Vade mecum' (2013), 33..

2845 Arts 6(2), 9(2) Reg 1466/96 (as amended).

2846 Arts 2-a(3); 2-ab(2); 6(2), 9(2) Reg 1466/97 (as amended). The Council must now automatically make the recommendation public on a proposal from the Commission, if raised: Arts 6(2); 10(2) Reg 1466/97 (as amended).

2847 Art -11 Reg 1466/97.

2848 Arts 6(2), 9(2) Reg 1466/97 (as amended). Revised recommendations may also be adopted under the same procedure.
the ‘six pack’, two pack, and TSCG. The remainder of this section 8.3 follows the MTO through each of these systems.

8.3.2 EU Legislation Vertically Integrates the Commission Warning into the TSCG

The second instrument of concern in this section is Article 5(2)(a) of Reg 473/2013, which inserts the EU MTO and the Commission warning under Article 6(1) of Reg 1466/97 into the constitutional correction mechanism under Article 3(1)(e) of the Treaty on Stability Coordination and Governance (TSCG). The centrepiece of the TSCG is the ‘Fiscal Compact’ with which it is synonymous. Having established that it is the Union under Articles 5(1) and 9(1) Reg 1466/97 – not the Member States – which choose the numerical value which becomes the object of enforcement, this section will show that the MTO is binding under Member State constitutional law as a result of Article 5(2)(a) of Reg 473/2013. This process is as follows:

[8.3.2.1] First, Article 3 TSCG requires the Contracting Parties to introduce a ‘balanced budget’ rule into national law through provisions ‘of binding force and permanent character, preferably constitutional, or otherwise guaranteed to be fully respected and adhered to throughout the national budgetary process.’ Under Article 3(1)(b) and 4 TSCG, compliance with this rule will be achieved where the annual structural balance is ‘within its country-specific MTO as defined in the Stability and Growth Pact’ or within the MTO adjustment path, also evaluated ‘in line with the revised Stability and Growth Pact.’

[8.3.2.2] Second, Article 3(1)(e) TSCG requires contracting parties to establish an automatic ‘constitutional correction mechanism,’ the trigger for which shall be a ‘significant observed deviations from the [MTO] or the adjustment path towards it.’ However, the TSCG itself does not link this to the Commission assessment of the significant observed deviation under Article 6(1) of Reg 1466/97. The Member States have not, by signing the TSCG, chosen to bind their constitutional laws to the Commission warning in the EU’s MSP procedure.

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2849 Arts 5-9 Directive 2011/85/EU operationalise the MTO in national law by requiring Member States (the UK excepting) to have in place a numerical fiscal rule at national level which ensures: (a) compliance with the 3% and 60% debt and deficit limits and (b) adherence to the MTO, (c) a 3-year budgetary framework, and (d) a requirement that annual budget legislation is consistent with the provisions of the MTO.

2850 In particular, the constitutional correction mechanism in Art 3(1)(e) of the TSCG and the rules governing national budgetary frameworks in Art 5(2) of Reg 473/2013. See: Section 8.3.2.

2851 The TSCG entered into force on 1 January 2013 for 16 Member States, and was ratified by all remaining signatories by 1 April 2014: Title III contains the ‘Fiscal Compact’ which bolsters the budgetary enforcement procedures of the SGP. Title IV is entitled ‘Economic Policy Coordination and Governance’ and Title V is entitled ‘Governance of the Euro Area.’ These titles include various supplementary cooperative provisions, including an undertaking to ‘work jointly’ and enact all measures and actions ‘necessary to ensure enhanced convergence and competitiveness’ (Art 9); stand ready to use the enhanced coordination procedures (Art 10); hold Euro summits not less than twice per year (Art 12); and ex-ante benchmarking discussions of policy coordination (Art 11). For comment: Peers, 'The stability treaty' (2012); Calleiss (2012), 113; Hinarejos, 'Limits to Fiscal Integration' (2014), 255.

2852 Arts 3(1) TSCG.

2853 Art 3(1)(b) TSCG.

2854 Art 3(1)(b) TSCG.

2855 Art 5(1) Reg 1466/97.
[8.3.2.3] Third, however, Article 5(1)(a) of Reg 473/2013 requires Member States to empower the ‘independent’ fiscal bodies discussed in 8.2.1.3 with triggering fiscal rules for the enforcement of the MTO ‘as established in Article 2a Reg 1466/97.’ Furthermore, under Article 5(2)(a) Reg 473/2013, the ‘independent’ fiscal body is required to make that assessment on the basis of the assessment made by the Commission under Article 6(2) of Reg 1466/97. It is here that Article 5(2)(a) of Reg 473/2013 – an instrument of binding EU law – stretches athwart the gap between legal orders and inserts the Commission warning in Article 6(2) into the TSCG. This co-opts the TSCG and requires Member States to hand the trigger for their constitutional correction mechanism to the Commission.

8.3.2.1 Component 1: The TSCG ‘Balanced Budget’ Rule

Article 3(1)(a) TSCG requires Contracting Parties to transpose the ‘balanced budget rule’ into their national legal systems, through binding (preferably constitutional) law guaranteed to be adhered through the national budgetary process. It states:

‘(1)(a) the budgetary position of the general government of a Contracting Party shall be balanced or in surplus;

(1)(b) the rule under point (a) shall be deemed to be respected if the annual structural balance of the general government is at its country-specific medium-term objective, as defined in the revised Stability and Growth Pact, with a lower limit of a structural deficit of 0.5% of [GDP].

The Contracting Parties shall ensure rapid convergence towards their respective [MTO]. The time-frame for such convergence will be proposed by the European Commission taking into consideration country-specific sustainability risks. Progress towards, and respect of, the medium-term objective shall be evaluated on the basis of an overall assessment with the structural balance as a reference, including an analysis of expenditure net of discretionary revenue measures, in line with the revised Stability and Growth Pact.

The most significant thing to emphasise about the ‘balanced-budget rule’ is that it is not a balanced-budget rule at all. As van Mallegheim points out, it ‘is really a rule to keep the structural budgetary position at its country-specific medium-term [and] therefore originates in the existing framework of

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2856 In full, Art 5(1)(a) states: ‘(1) Member States shall have in place independent bodies for monitoring compliance with:
(a) numerical fiscal rules incorporating in the national budgetary processes their medium-term budgetary objective as established in Article 2a of Regulation (EC) No 1466/97.’

2857 Art 5(2)(a) of Reg 473/2013 states: ‘Those bodies shall, where appropriate, provide public assessments with respect to national fiscal rules, inter alia relating to: The occurrence of circumstances leading to the activation of the correction mechanism for cases of significant observed deviation from the medium-term objective or the adjustment path towards it in accordance with Article 6(2) of Regulation (EC) No Reg 1466/97’ - the Commission’s autonomous assessment and warning under the MSP (see Section 8.3.1.3).

2858 Emphasis added. Note also: Art 3(3) TSCG states: ‘For the purposes of this Article, the definitions set out in Article 2 of the Protocol (No 12) on the excessive deficit procedure, annexed to the European Union Treaties, shall apply.’
the fiscal supervision of EU Member States.\textsuperscript{2859} Member States must be at their MTO ‘as defined in the Stability and Growth Pact’ or the MTO adjustment path, also evaluated in line with the revised Stability and Growth Pact,\textsuperscript{2860} and deviations may only be excepted in exceptional circumstances defined in identical terms to those of the Stability and Growth Pact.\textsuperscript{2861}

The function of Article 3(1) TSCG is therefore to legislate compliance with the MTO defined under EU law in the context of the SGP. Indeed, the TSCG overlaps with Article 5 of Directive 2011/85/EU, which requires Member States to enact numerical rules which ensure respect for the MTO established under the SGP, and these rules may be the same (see Section 8.3.3).\textsuperscript{2862} In a rather neat coup, the result is that economic criteria at EU level (where there is no competence for fiscal policy) are now enforced on the EU’s behalf by national constitutional courts. Fabbrini concludes:

‘The Fiscal Compact is bringing about centralization in the governance of the Euro-zone that is significantly greater than that existing in the United States. […] This is ironic considering that EU member states have systematically discarded a federalist arrangement for the governance of the Euro-zone as being incompatible with state sovereignty.’\textsuperscript{2863}

\textbf{8.3.2.2 Component 2: Significant Observed Deviation and the Fiscal Compact}

Under Article 3(1)(e) and 3(2) TSCG, Member States must have in place a constitutional ‘correction mechanism,’ the trigger for which shall be a ‘significant observed deviation from the [MTO] or the adjustment path towards it’ unless it qualifies for one of the escape clauses provided for under EU law. Those articles state:

‘(1)(e) in the event of significant observed deviations from the [MTO] or the adjustment path towards it, a correction mechanism shall be triggered automatically. The mechanism shall include the obligation of the Contracting Party concerned to implement the measures to correct the deviations over a defined period of time.

2. The rules out in paragraph 1 shall take effect in the national law of the Contracting Parties at the latest one year after the entry into force of this Treaty through provisions of binding force and permanent character, preferably constitutional, or otherwise guaranteed to be fully

\textsuperscript{2859} The rule was initially proposed as an emulation of the debt brake established under the German Basic Law in 2009. Heinen (2010); Feld and Baskaran (2010). It is not: Van Malleghem (2014), 163.

\textsuperscript{2860} Art 3(1)(b) TSCG. As each SCP must be based on ‘differentiated MTOs’, this means that the MTO pursued throughout the European Semester must be at least -0.5%, but it does not mean that the MTO under the TSCG is different than that set under Art 2a of Reg 1466/97. Art 3(1) TSCG is explicit that they are the same. Article 4 TSCG then similarly imports the adjustment path for excessive debts under Article 2(1a) of Reg 1467/97 into the TSCG: ‘When the ratio of a Contracting Party’s general government debt to [GDP] exceeds the 60% reference value referred to in Article 1 of the Protocol (No 12) on the [EDP], that Contracting Party shall reduce it at an average rate of one twentieth per year as a benchmark, as provided for in Article 2 of [Reg 1467/97, as amended]. The existence of an excessive deficit due to the breach of the debt criterion will be decided in accordance with the procedure set out in Article 126 [TFEU].’

\textsuperscript{2861} ‘an unusual event outside the control of the Contracting Party’ with a major impact on the general government financial position, or periods of severe economic downturn (again as defined in the SGP): Arts 3(1)(c), 3(3)(b) TSCG.

\textsuperscript{2862} Art 2a Reg 1466/97 as amended by Art 1(5) Reg 1175/2011.

\textsuperscript{2863} Fabbrini (2013), 35.
respect and adhered to throughout the national budgetary processes. The Contracting Parties shall put in place at national level the correction mechanism referred to in paragraph 1(e) on the basis of common principles to be proposed by the European Commission, concerning in particular the nature, size and time-frame of the corrective action to be undertaken, also in the case of exceptional circumstances, and the role and independence of the institutions responsible at national level for monitoring compliance with the rules set out in paragraph 1. Such correction mechanism shall fully respect the prerogatives of national Parliaments.’

It must be recalled that, under Article 6(2) of Reg 1466/97, it is the Commission alone which is empowered to ‘monitor the implementation of stability programmes … with a view to identifying actual or expected significant divergences’ from the MTO adjustment path and issue an autonomous warning to the Member State under Article 121(4) TFEU. 2864

Prima facie, the principle of harmonious interpretation implies that the constitutional correction mechanism should be triggered by the Commission warning under Art 6(2) of Reg 1466/97. Indeed, the Commission’s Principles on national correction mechanisms intends this explicitly. 2865 Nonetheless, it must be emphasised that there is nothing in the TSCG itself which requires the mechanism to be triggered by the Commission’s ‘warning’ under Regulation 1466/97. Indeed, the explanatory note on this principle explains that while ‘EU-level decisions establishing the occurrence of a significant deviation would be a natural trigger for corrections mechanisms,’ ‘trigger points may rely on either EU-level criteria, country-specific criteria, or both.’ 2866 Under the terms of the TSCG, the Member States have not bound themselves to hand control of their constitutional enforcement mechanism to the Commission.

8.3.2.3 Component 3: Secondary EU Law Binds the Constitutional Correction Mechanism

It is here that Article 5(2)(a) of Regulation 473/2013 – an instrument of binding EU law – stretches athwart the gap between legal orders and completes the link between Article 6(2) of Reg 1466/97 and the TSCG. As discussed in Section 8.2.1.2 above, under Article 5(1)(a) of Reg 473/2013 it is the ‘independent’ fiscal bodies which are responsible for are responsible for triggering the constitutional correction mechanism of the TSCG, which incorporates, into in the national budgetary process, the MTO ‘as established in Article 2a Reg 1466/97.’ 2867 Article 5(2)(a) Reg 473/2013 then states that the

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2864 See Section 8.3.1.3. Arts 6(2), 9(2) Reg 1466/96 (as amended) read: ‘In the event of a significant observed deviation from the adjustment path towards the [MTO] referred to in the third subparagraph of Article 5(1) of this Reg … the Commission shall address a warning to the Member State concerned in accordance with Article 121(4) TFEU.’

2865 Communication from the Commission of 20 June 2012, Common principles on national fiscal correction mechanisms COM(2012) 342. ‘National correction mechanisms shall rely closely on the concepts and rules of the European fiscal framework. This applies in particular to the notion of a ‘significant deviation’ and the definition of possible escape clauses.’


2867 Art 5(1)(a) Reg 473/2013 (emphasis added).
'independent' fiscal body is required to make that assessment on the basis of an assessment made by the Commission under Article 6(2) of Reg 1466/97:

‘Those bodies shall, where appropriate, provide public assessments with respect to national fiscal rules, inter alia relating to: (a) the occurrence of circumstances leading to the activation of the correction mechanism for cases of significant observed deviation from the [MTO] or the adjustment path towards it in accordance with Article 6(2) of [Reg 1466/97].

The national constitutional trigger is therefore wired to the MSP and placed in the autonomous hands of the Commission warning under Article 6(2) Reg 1466/97. It is an instrument of EU law which inserts the ‘significant observed deviation’ - defined, identified and activated by the Commission under Article 6(2) Reg 1466/97 - into the Member State TSCG. A failure of the EU-legislated ‘independent’ fiscal council to activate the mechanism upon the Commission warning will, in principle, constitute a breach of Article 5(2)(a) of Reg 473/2013.

This interpretation is broadly accepted among EU institutions and national authorities alike. Ireland’s Medium-Term Budgetary Framework, for example, states that its automatic correction mechanism is triggered automatically, ‘if the European Commission addresses a warning under Article 6(2) of Reg 1466/97.’ 14 Member States have interpreted the law this way, placing independent fiscal councils in charge of triggering national correction mechanisms on the basis of the Commission warning automatically. However, according to the ECB and the Commission, those are not in compliance with Reg 473/2013.

Once triggered, the content of the legal correction imposed on the budgetary process is also effectively legislated by EU institutions. Article 3(1)(e) TSCG states that the constitutional correction mechanism ‘shall include the obligation of the Contracting Party to implement measures to correct the deviations over a defined period of time,’ proposed by the Commission on the basis of

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2868 Reg 473/2011 (emphasis added).

2869 NB: It might be argued that this is not necessarily entailed, since it is not explicit from Article 5(2)(a) Reg 473/3013 that the ‘correction mechanism for cases of significant observed deviation’ is that article is the same ‘correction mechanism for cases of significant observed deviation’ in the TSCG. However as there is no other ‘correction mechanism’ for a ‘significant observed deviation’ anywhere else in the legal framework, this appears to be an obvious and necessary interpretation.

2870 Medium-Term Budgetary Framework (2014), 36 [emphasis added].

2871 Belgium, Bulgaria, Estonia, Spain, France, Croatia, Italy, Cyprus, Lithuania, Luxembourg, Austria, Portugal, Romania, Slovakia. See: ECB, 'Fiscal Councils in EU Countries' (2014), 97.

2872 Denmark, Germany, Ireland, Greece, Hungary, Malta, the Netherlands, Slovenia, Finland and Sweden.

2873 ECB, 'Fiscal Councils in EU Countries' (2014), 98 states: ‘Not all fiscal councils in the euro area countries seem to have mandates what are fully in line with the requirements set out in the two-pack. In most countries, the mandate of the fiscal council typically focuses on monitoring compliance with fiscal rules. In less than half of the EU Member States, fiscal councils also play a role in monitoring or assessing the activation of the correction mechanism, as spelled out in the Fiscal Compact, in case of considerable deviation from fiscal rules.’ European Commission, 'Vade mecum' (2013), 13 states: ‘in the case of significant observed deviations from the MTO or the adjustment path towards it - the SGP concept - correction mechanisms will be triggered automatically at the national level.'
an assessment conducted ‘in line with the revised Stability and Growth Pact.’ Since these variables are determined at EU level under the MSP, the Commission and Council can be assured that the assessment of the appropriate MTO will be enforced by national constitutional courts. Under Ireland’s automatic correction mechanism, for example, the Commission warning automatically triggers a correction plan (Section 6 of the Fiscal Responsibility Act 2012 (Ireland)), which will ‘set out the size and nature of the planned revenue and expenditure measures to be taken,’ and which ‘must be consistent with European Council recommendations.’ For the assuaual of doubt, Principle (2) of the Commission’s common principles states: ‘The correction, in terms of size and timeline, shall be made consistent with possible recommendations addressed to the concerned Member State under the [SGP].

The conjunctive effect of Articles 3(1)(e) TSCG, 6(2) Reg 1466/97, and 5(2)(a) Reg 473/2013 is that the Commission is given the power to set national budget targets and trigger enforcement of its rules in both national and EU law. Through the interaction of these provisions, the adjustment path towards the MTO is now set by the Commission under Article 3(1)(b) TSCG, and it is the adjustment path of the Commission which takes on legal force under the automatic correction mechanism of Article 3(1)(e) TSCG. Furthermore, since it is the Commission which identifies a significant observed deviation under Article 6(2) Reg 1466/97, the principle of harmonious interpretation under Article 2 TSCG would necessarily imply that the Commission warning under the MSP would trigger the national law correction mechanism under Article 3(1)(e) TSCG as well. What makes this legally problematic, however, is that it is Article 5(2)(a) Reg 473/2013 – directly-applicable and supreme EU law - which inserts this link. It is a binding instrument of EU law – not an intergovernmental treaty – which requires Member States to give direct enforcement to the EU’s MTO upon the Commission’s warning in Article 6(2) Reg 1466/97. In that event, the outcome would be no different than if the Commission warning or Council recommendation had direct effect in national constitutional law.

Figure 38 Constitutional Correction Mechanisms and the Competence Fence: Crossing the Line

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2874 Article 3(1)(b) TSCG states that Member States are to ensure convergence towards their MTO’s following a timeline proposed by the Commission. See also: Commission, ‘Common principles’ COM(2012) 342
2875 Ireland, Medium-Term Budgetary Framework (2014), 36.
8.3.2.4 Assessment: A Manifest Breach of the European Legal Order

This is extremely problematic for the subject-matter of this thesis. The EU-law alternative to this mechanism - i.e., a regulation based on Article 126 TFEU or 136 TFEU binding on national budgets - would surely be struck down by EU or national courts as ultra vires and a violation of constitutional identity.\(^\text{2877}\) This is why the TSCG was signed outside the European legal order in the first place. The objective of the TSCG, ‘domestic legal and constitutional change,’\(^\text{2878}\) through ‘provisions [which] cannot be simply altered by the ordinary budgetary law,’\(^\text{2879}\) simply could not be effected by secondary EU legislation.\(^\text{2880}\) However, it remains heavily intertwined with EU law, and at least two vital pieces of this machine – the establishment of independent fiscal councils and the triggering of the TSCG - are set out in a Directive and Regulation, which are binding under EU law.

To top off this enmeshment, the Commission and Council have worked country-specific, sanction-backed recommendations about the implementation of the correction mechanism into the European Semester.\(^\text{2881}\)

In that regard, it must be recalled that the test for an unconstitutional restrictions on budgetary sovereignty is whether it could be reversed by an equivalent unilateral action of the elected parliament in the future.\(^\text{2882}\) The TSCG, as an intergovernmental treaty, passes this test.\(^\text{2883}\) Article 5(2)(a) of Reg 473/2013, however, does not.

The first proof for this proposition is the BVerfGE’s decision in *Re ESM II (Germany)*. In that case, the court held that the TSCG correction mechanism was a lawful restriction on the budgetary

\(^{2877}\) As Armstrong (2013) points out, according to the French Senate and Opinion 2/94 of the ECJ, the protection of constitutional identity precludes a secondary act of EU law from affecting national constitutional change. See: Opinion 2/94 *Accession of the Community to the European Human Rights Convention* [1996] ECR 1-1759 (deciding that there is no power available in the Treaty to create constitutional rights recognised in the constitutional laws of Member States); Resolution of January 24 2012 (Session 2011-12) <http://www.senat.fr/leg/ta11-053.html> accessed 25 March 2015 (asserting that Art 4 TEU demands respect for national constitutions, precluding a demand for constitutional change from arising in a secondary act under EU law).

\(^{2878}\) See, Armstrong (2013).


\(^{2880}\) Alternative initiatives, either to replace Protocol No 12 or amending the Treaty through Article 48 TEU - were opposed on the basis of competence and ‘bypassing proper democratic scrutiny and lacking sufficient legitimacy.’ See: Editorial, 'Draft Treaty on a Reinforced Economic Union' (2012). This suggests, as Besselinke and Reestman (2012), 5 point out, the ‘EU Treaties themselves, evidently, are insufficient to master the problems of governing the economy under the Union’s own monetary system.’ See also: Fabbrini (2013), 3-7; Calleiss (2012), 105; Armstrong (2013), 604. Cf. Peers, 'The stability treaty' (2012), 441; Hinarejos, 'Limits to Fiscal Integration' (2014), 256; Calleiss (2012).

\(^{2881}\) Boggero and Annicchino (2014): ‘it is worth bearing in mind that the whole constitutional revision procedure was intertwined with several EU acts issued by EU institutions.’ See, e.g., Council Recommendation of 10 July 2012 on the National reform Programme 2012 of Italy [2012] OJ C 219/14, at (11) (issued after Italy’s amended balanced budget law had already been enacted, the recommendation states that further implementing legislation is necessary).

\(^{2882}\) See: Section 1.3.1, in particular Section 1.3.1.4. The standard applied, according to the BVerfGE, is that ‘the democratic process remains open and that legal re-evaluations may occur on the basis of other majority decisions and that an irreversible legal prejudice to future generations is avoided.’ *Re ESM II (Germany)* [173].

\(^{2883}\) *Re ESM II (Germany)* [173].
autonomy of the Bundestag. This was so because the TSCG, as an intergovernmental Treaty, could be reversed by an equivalent action of the parliament in the future.\textsuperscript{2884} The court held:

‘The [TSCG] grants the bodies of the European Union no powers which affect the overall budgetary responsibility of the German Bundestag and does not force [Germany] to make a permanent commitment regarding its economic policy that it can no longer reverse. It is true that... the Contracting Parties rely on principles which are to be proposed by the European Commission and which concern in particular the nature, size and time-frame of the corrective action to be taken (including under exceptional circumstances), and the role and independence of the institutions responsible at the national level for monitoring compliance with the deficit and indebtedness criteria. This, however, does not grant the European Commission authority to impose specific substantive requirements for the structuring of the budgets.\textsuperscript{2885}

This is no longer the case. Regulation 473/2013 was enacted after the Re ESM (Germany) litigation was brought before the BVerfGE, and that legislation was not in issue. However, as shown above, the conditions set out for the constitutionality of the TSCG in Germany are no longer intact: Article 5(2)(a) Reg 473/2014 does grants the Commission the power to trigger the constitutional mechanism which affects the budgetary responsibility of the Bundestag; Regulation 473/2013 is directly applicable and supreme EU law which does force Germany to make permanent commitment that is not reversible by an equivalent majority of the Bundestag in the future; and Reg 473/2013 does grant the European Commission the authority to impose specific substantive requirements for the structuring of the budgets. According to this decision, the addition of 5(2)(a) Reg 473/2013 to the TSCG framework no longer meets the constitutional identity test in Germany.

Second, in Re TSCG (France) the Conseil Constitutionnel held that the TSCG did not ‘infringe the essential conditions for the exercise of national sovereignty’ because, first, ‘these provisions do not define either the procedures according to which this mechanism must be triggered or the measures which must be implemented as a result’; and, second, they left Member States free to define these procedures in accordance with their own constitutional law.\textsuperscript{2886} It stated:

‘Considering that the "correction mechanism" which the States undertake to put in place must be "triggered automatically "in the event of significant observed deviations from the medium-term objective or the adjustment path towards it" and must include "the obligation of the Contracting Party concerned to implement measures to correct the deviations over a defined period of time"; that the provisions of the Treaty imply that the implementation of this correction mechanism will lead to measures regarding all public administrations, especially the State, local government and social security bodies; that these provisions do not define either the procedures according to

\textsuperscript{2884} Re ESM II (Germany), [164], [168], [173], [242]-[245].
\textsuperscript{2885} Re ESM II (Germany), [242]-[245].
\textsuperscript{2886} TSCG (France) [26]-[27].
which this mechanism must be triggered or the measures which must be implemented as a result; that they therefore leave the States free to determine these procedures and measures in accordance with their constitutional law.2887

Once again, this is no longer the case. This decision was also issued before Regulation 473/2013 was enacted, and so Article 5(2)(a) was not in issue. However, Article 5(2)(a) of Reg 473/2013 now, first, defines the procedures according to which this mechanism must be triggered; and, second, since the trigger is in directly applicable and binding EU law, they no longer leave the states free to determine these procedures in accordance with their constitutional law.

Third, in TSCG (Austria), the VfGH ruled that a special amendment of the federal constitution was not necessary to ratify the TSCG because it granted no power to the Union beyond that already granted under the Austrian Accession Act.2888 The court held that, because it was a purely intergovernmental treaty, it fell within ‘part of its policy-making role within the democratic parliamentary system foreseen by the Federal Constitutional Act.’2889 It held:

‘The fiscal Compact is a treaty under international law outside the scope of Union Law … neither is the transfer of competences to the European Union bodies of such nature which would exceed the scope of what is admissible under constitutional law, nor are the constitutional law provisions which govern the federal budget thereby violated.’2890

This decision will also need to be revisited. The VfGH examined the ‘six pack,’ but the ‘two pack’ and Regulation 473/2013 was not in issue. However, Regulation 473/2013 is not part of the executives’ policy-making role within the Federal Constitutional Act and it is not part of an international treaty outside the scope of Union law. As noted in Section 1.2.2.1, this would seem to require the GesamÄnderung procedure under Article 44(3) of the Constitution to ratify.2891 In Re ESM (Austria), for example, the VfGE ruled that a conferral of budgetary policy on the Union would amend fundamental principles of the constitution, and be unconstitutional.2892 The TESM did not do so, because it did not hand the EU a power to dictate economic policy. Article 5(2)(a) of Reg 473/2013 does do so, however, and Re ESM (Austria) indicates that TSCG (Austria) would necessarily have to have been decided differently.

2887 TSCG (France) [26]-[27].
2889 TSCG (Austria).
2890 TSCG (Austria).
2891 A total revision requires not only a two-thirds majority in Parliament (the ordinary revision procedure), but also a positive vote in a referendum. Austrian Federal Constitution, art 44(3). See: Griller (2001), 148.
2892 In ESM (Austria) the VfGH upheld the ratification of the ESM Treaty under Art 9(2) as being sufficiently ‘specific and limited’ because it provided for a capped amount of financial contribution. A contrario, it means that such an open-ended commitment would be unconstitutional if conferred on a body other than the EU. See, e.g., Mayer (2013), 399.
The final proof for this can be seen in the European Legal Service’s opinion on Article 8 TSCG. Under Article 8(1) TSCG, if the Commission concludes that the party has failed to comply with the obligation to enact the constitutional correction mechanism, the matter ‘will be brought to the Court of Justice by one or more Contracting Parties.’ This presents an analogous problem to that of Reg 473/2013. As Craig observes:

‘This cannot conceal the substantive reality, which is that Art 8 TSCG is seeking to do by the back door what it cannot do by the front. Article 8 TSCG gives the Commission the “trigger” as to whether a legal action should be brought.’

The European Legal Service is of the opinion that this does not make the Commission the initiator of the action, because ‘an act of a Member State taken in a situation of “tied competence” remains an act of this Member State.’ This is convincing. However, if that is so, this leaves Article 5(2)(a) of Reg 473/2013 much more exposed altogether. It must be recalled that it is not the intergovernmental TSCG which requires Member States to give effect to the Commission warning under Article 6(2) of Reg 1466/97 - it is a provision of EU law which does so. In this case, the fetter tying the Member State to EU law is an instrument of EU law. A fortiori, this is an ultra vires act, according to the European Legal Service’s reasoning under Article 8 TSCG.

For these four reasons, this thesis concludes that Article 5(2)(a) of Reg 473/2013 is in violation of the principle of conferral and constitutes a serious trespass of the European legal order striking at the core of constitutional identity in order for the TSCG and Regulation 1466/97 to be reconcilable with the European legal order, Article 5(2)(a) of Regulation 473/2013 must be amended so as to withdraw the insertion of the Commission trigger from the TSCG framework. Until this is done, this mechanism cannot be effective; and in so far as it proves effective, then vulnerable to repudiation according to at least three constitutional identity jurisdictions identified in this thesis. Given that Member States are anyways likely to define their mechanisms on the basis of Article 6(2) of Reg 1466/97 of their own accord, this is an utterly unnecessary and needlessly risky over-extension of EU law.

8.3.3 Directive 2011/85/EU Binds Member States to EU-Legislated Fiscal Rules

The third mechanism that vertically integrates EU fiscal governance with Member State legal orders is Directive 2011/85/EU. That instrument seeks, in no uncertain terms, to amend national fiscal

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2893 Art 8(1) TSCG. The CJEU’s ruling will then be binding on the parties, which will take the necessary measures to comply with the decision. A protocol to the Treaty explains that the duty to bring the claim belongs to the trio Council Presidency (Article 16(9) TEU), which must file the action within three months of the submission of the Commission’s report. Alternatively, under Art 8(2), the Contracting Parties have an independent discretion to bring (the case where it considers that another party has failed to implement the TSCG. For comment: Calleiss (2012), 111.

2894 Craig, ‘Stability, Coordination and Governance Treaty’ (2012), 246, noting: ‘More important is the fact that if the Commission produces a negative report on a contracting state, this triggers a mandatory obligation on another contracting party to bring the recalcitrant state to the ECJ.’

frameworks so as to bind them to EU fiscal rules. Article 1 states this explicitly: ‘This Directive lays down detailed rules concerning the characteristics of the budgetary frameworks of the Member States… necessary to ensure Member States’ compliance with obligations under the TFEU.’\(^\text{2896}\) It should be noted in that regard that ‘compliance’ is far stricter than the requirement of ‘consistency’ found to constitute a binding obligation in Section 8.2.2, above. In Ledra v Commission and ECB, AG Wahl explained:

‘the two terms of “compliance” and “consistency” should not be confused. Indeed, from a legal standpoint, they refer to two rather different concepts: the former requires obedience and full conformity between two texts, whereas the latter is satisfied by the mere compatibility and non-contradiction between them.’\(^\text{2897}\)

Notably, this objective entails more than just establishing a general requirement for fiscal rules - it prescribes their substantive content. Recital 12 of the proposal for Directive 2011/85/EU, for example, states that ‘National fiscal planning can only be consistent with [Regs 1466/97 and 1467/97] if it pursues the achievement of the medium-term objectives in particular.’\(^\text{2898}\) In other words, the Directive is intended to make sure the deficit, debt and MTO numerical values under EU law are automatically reproduced and binding in national law. The machinery constructed here has three components.

\textbf{8.3.3.1 Component 1: EU Law Requires Member States to Legislate EU Fiscal Rules}

First, Article 5 of Directive 2011/85/EU operationalises the EU’s fiscal rules by requiring that laws be enacted at national level which ‘effectively promote compliance’ with the MTO and the 3% deficit and 60% debt limits in the Treaty. It states:

‘Each Member States shall have in place numerical fiscal rules which are specific to it and which effectively promote compliance with its obligations deriving from the TFEU in the area of budgetary policy... Such rules shall promote in particular:

(a) compliance with the reference values on deficit and debt set in accordance with the TFEU;

(b) the adoption of a multiannual fiscal planning horizon, including adherence to the Member State’s medium-term budgetary objective.’\(^\text{2899}\)

\(^{2896}\) See also: European Commission, Proposal for a Council Directive on budgetary frameworks COM(2010) 523 final, rec 28: ‘strong national fiscal rules that are consistent with the budgetary objectives at the level of the Union’ are a cornerstone of the ‘budgetary surveillance framework of the union.’

\(^{2897}\) Ledra (Opinion of AG Wahl) [73].


\(^{2899}\) (Emphasis added). Art 6(2) Directive 2011/85/EU further harmonises escape clauses: ‘If numerical fiscal rules contain escape clauses, such clauses shall set out a limited number of specific circumstances consistent with the Member States’ obligations deriving from the TFEU in the area of budgetary policy, and stringent procedures in which temporary non-compliance with the rule is permitted.’

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The duty to ‘effectively promote compliance’ is a novel imperative that is usually interpreted as a duty to establish some financial penalty or dis-incentive which comes to bear on rule-breakers. This is unlikely to be sufficiently clear and precise to require Member States to give direct effect to the 3% deficit, 60% debt and MTO as a matter of law.

8.3.3.2 Component 2: EU Law Binds Member States as to the Result to be Achieved

However, Directive 2011/85/EU must be read in combination with Article 2a of Reg 1466/97, which provides:

‘The respect of the [MTO] shall be included in the national medium-term budgetary frameworks in accordance with Chapter IV [Article 5] of [Directive 2011/85/EU].’

This effectively amends the language of ‘promote compliance’ to ‘shall respect’ where it concerns the MTO. This is capable of constituting a sufficiently clear and precise obligation under EU law. In Commission v Hungary, for example, the ECJ held that the duty, ‘Member States shall respect the right of providers to provide services in a member State other than that in which they are established’ prohibited Member States from enacting legislation that imposed an obligation on firms to have an establishment in their territory. Similarly, the duty to ‘respect’ basic Treaty freedoms in the exercise of Member State competence and the duty to ‘respect’ the principle of non-refoulement have been found binding when they are in issue. This does make respect of the MTO directly applicable under binding and supreme EU law. This is made explicit by Articles 7 and 10 of Directive 2011/85/EU, which state that the ‘annual budget legislation of the Member States shall reflect country-specific numerical rules in force’, and that annual budget legislation ‘shall be consistent with the provisions of the medium-term budgetary framework’ legislated by the directive.

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2900 See, e.g., Case C-11/12 Langestraat en Langestraat-Troost v Staatssecretaris van Economische Zaken (First Chamber, 13 December 2012) [35]; Case C-384/02 Grongaard and Bang [2005] ECR I-09939 (Opinion of AG Maduro) [24].
2901 See, by analogue: Case C-301/10 Commission v UK (Urban waste water) (First Chamber, 18 October 2012) [64]: The concept at issue [which ‘promotes compliance’ with Directive 91/271] ‘thus enables compliance with the obligations of Directive 91/271 to be secured without imposing upon the Member States unachievable obligations which they might not be able to fulfil, or only at disproportionate cost.’
2902 The case law is replete with other examples: e.g. Case C-342/14 X-Steuerberatungsgesellschaft (Fourth Chamber, 17 December 2015) [25]-[47] (the duty to respect basic freedoms guaranteed by the Treaty in their exclusive competences); Case C-373/13 T v Land Baden-Württemberg (First Chamber, 25 June 2015) [42] duty to respect the principle of non-refoulement is binding where it is an issue.
2903 Case C-170/14 Commission v Hungary (Grand Chamber of the ECJ, 23 February 2016)[102]. See also: Case C-342/14 X-Steuerberatungsgesellschaft (Fourth Chamber, 17 December 2015) [25]-[47] (the duty to respect basic freedoms guaranteed by the Treaty in their exclusive competences); Case C-373/13 T v Land Baden-Württemberg (First Chamber, 25 June 2015) [42] (duty to respect the principle of non-refoulement is binding where it is an issue).
2904 Other relevant examples include the duty to ‘respect’ Member State identities under Article 4 TEU, and the duty to ‘respect the prerogatives of national Parliaments’ under Article 3(2) TSCG.
2905 Art 7 Directive 2011/85/EU.
2906 Art 10 Directive 2011/85/EU.
8.3.3.3 Component 3: EU Law Binds the Enforcement Mechanism

As shown in Section 8.2.1.3, Articles 6(1)(b) of the Directive and 5(1) of Reg 473/2013 then require Member states to place compliance with these rules in the hands of the independent bodies examined in Section 8.2.1.2. Article 6(1)(b) states that country-specific numerical fiscal rules must be based on those independent bodies:

‘the effective and timely monitoring of compliance with the rules, based on reliable and independent analysis carried out by independent bodies or bodies endowed with functional autonomy vis-à-vis the fiscal authorities of the Member States;’

Article 5(1)(b) of Reg 473/2013 imbues those independent bodies with a legal mandate to enforce the MTO using numerical rules under the Directive:

‘Member States shall have in place independent bodies for monitoring compliance with:

(a) numerical fiscal rules incorporating in the national budgetary processes their [MTO] as established in Article 2a [Reg] 1466/97;

(b) numerical fiscal rules as referred to in Article 5 of Directive 2011/85/EU.’

Here it must be recalled that the MTO enshrined in this obligation is not freely chosen by the Member States. The MTO in Article 2a is the same MTO shown above to be determined by the Commission and the Council under three separate constellations of provisions mapped this chapter.

This is quite remarkable. Instruments of EU law cannot lawfully compel Member States to implement economic edicts for which the Union has no competence. EU legislation cannot - as national legislation might - bind the budgetary powers of the elected executive or legislature to a certain numerical target (see Article 2(c) of Directive 2011/85/EU); set procedural rules which govern the entirety of the legislative process (Article 2(d)); set rules governing the setting of policy priorities and budgetary objectives (Article 2(e)); regulate the constitutional relationships between levels of government in a Member State (Article 2(g)); or govern the setting of economic policy priorities for national governments and legislatures (Article 2(3)). And yet, Directive 2011/85/EU, on its face, professes to do all these things. It does not do so directly however - such legislation

2907 Art 7 Directive 2011/85/EU.
2908 Art 5(1) Reg 473/2013.
2909 First, [8.2.1] Article 4(1) of Directive 2011/85/EU states that the Member State’s own calculation of the MTO in Article 5(b) must be based on the most likely forecast assessed against the Commission’s under a ‘comply or explain’ rule, and for Euro countries, this must be produced or endorsed by independent fiscal councils legally and functionally governed by the Commission; [8.2.2] the Commission and Council have an effective veto over inconsistent Member State MTOs under Reg 473/2013; and [8.3.1] the MTO in Article 2a is the same MTO shown in the preceding section of this thesis to be determined by the Union under Articles 5 and 9 of Reg 1466/97
2910 Art 2 Directive 2011/85/EU.
would be overtly *ultra vires*. Instead, the Directive seeks to establish or amend national laws which *do* accomplish all these things.

### 8.3.3.4 Assessment: A Manifest Breach of Competence

The result is a remarkable circumvention of the plain barriers of competence under EU law. Secondary EU law places Member States under a legal duty, to place themselves under a legal duty, to comply with the EU’s fiscal rules - which themselves are not legal duties. A Member State whose budgetary framework allows budgetary legislation to breach the EU’s numerical rules will be in breach of EU law – even though the numerical rules themselves are not binding EU law.

There is nothing in Directive 2011/85/EU or Regulation 483/2013 to enable one to avoid this conclusion. Under Article 288(3) TFEU, a directive is binding. As the ECJ has ruled:

‘[I]t should be recalled that the provisions of a directive must be implemented with unquestionable binding force and with the specificity, precision and clarity necessary to satisfy the requirements of legal certainty. … [A directive] impose[s] an obligation on the Member State to adopt all the measures necessary to ensure that the provisions of [a Directive] were fully effective and so guarantee achievement of the prescribed result.’ ²⁹¹¹

This cannot be other than a breach of competence. The legal basis for Directive 2011/85/EU is 126(14) TFEU, which provides a basis for laying down detailed rules and definitions for how the excessive deficit procedure is to be applied at EU level.²⁹¹² It does not provide a general competence to enact legal measures to ensure fiscal discipline in the Member States. Curiously, however, this is how Directive 2011/85/EU describes its objectives:

‘Since the objective of this Directive, namely *uniform compliance with budgetary discipline* as required by the TFEU, cannot be sufficiently achieved by the Member States and can therefore be better achieved at the level of the Union, the Union may adopt measures, in accordance with the principles of subsidiarity as set out in Article 5 of the TEU. In accordance with the principle of proportionality, as set out in that Article, this Directive does not go beyond what is necessary in order to achieve that objective.’ ²⁹¹³

This is a passage on subsidiarity to justify EU competence in an area of shared competence. This entails that: (a) the objective cannot be achieved sufficiently by the Member States acting

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²⁹¹¹ Case C-277/13 *Commission v Portugal* unreported, 11 September 2014, [43], [44]. (Failure to transpose Directive 96/67/EC not vitiated by the fact that delay attributable, in part, to MoU signed with the Commission and ECB). See also: Joined Cases C-179,179,188-190/94 *Dillenkofer and others* [1996] ECR I-4867 [48] First of all, according to settled case-law, the provisions of a directive must be implemented with unquestionable binding force and with the specificity, precision and clarity necessary to satisfy the requirements of legal certainty.’

²⁹¹² Art 126(14) TFEU reads: ‘Subject to the other provisions of this paragraph, the Council shall, on a proposal from the Commission and after consulting the European Parliament, lay down detailed rules and definitions for the application of the provisions of the said Protocol.’

²⁹¹³ Rec 28, Directive 2011/85/EU (emphasis added).
individually, and (b) that it can achieve the objective better than the Member States. There are three glaring problems with this. First, the stated objective of the Directive is ‘uniform compliance with budgetary discipline as required by the TFEU.’ However, the EU has no competence to achieve ‘uniform compliance’ with budgetary discipline, or ensure budgetary discipline at all. Budgetary discipline is not even a legal duty on the Member States. Article 126(10) TFEU is quite clear: The 3% and 60% reference values are not binding under EU law.\footnote{2914} Second, even if there was such a competence (which there is not) the notion that the EU can better manage national budgets according to the principle of subsidiarity - even where there are no spillovers to the Union as a whole - is so self-evidently flawed that it questions the entire basis for a democratic state. It cannot succeed without overcoming the inference that Europe’s twenty-eight advanced constitutional democracies are so incapable of governing their own finances that their budgetary powers must be exercised by the Union. This is likely why the objective is described in terms of ‘uniform compliance’ with budgetary discipline, instead of ‘compliance’ with budgetary discipline – Member States alone cannot make it ‘uniform.’ But this, too, has no basis in EU law. Where does this requirement to be ‘uniform’ even come from? Must all Member States have debt and deficits at the same level? Surely not. But if compliance is universal, but not uniform, then one must revert to the dubious conclusion that the EU can ‘do it better.’

Third, in any event, it should be decisive that subsidiarity only governs the use of Union competences, and there is no competence to ensure uniform budgetary compliance in the Member States.\footnote{2915} Here, the competence to facilitate Member State coordination under EDP has been interpreted by the authors of Directive 2011/85/EU as a competence to amend national budgetary laws so that the debt/deficit values - plus a third variable, the MTO, found nowhere in the Treaty - takes effect in national law. This constitutes severe ultra vires breach going to the core of budgetary sovereignty. The unavoidable conclusion is that Directive 2011/85/EU cannot be binding, and in so far as it is binding, is ultra vires EU law. An action against a Member State for, say, failing to implement Directive 2011/85/EU because of a failure to achieve its country-specific MTO would yield yet another instrument that ‘can perhaps only exist so long as it is not made use of.’\footnote{2916}

8.3.4 The Effect of Reverse ‘Super’-QMV

The final issue raised by the fiscal governance framework is the introduction of RQMV throughout both limbs of the procedures enacted under Articles 121 and 126 TFEU. It must be recalled that,

\footnote{2914} Art 126 TFEU: ‘The rights to bring actions provided for in Articles 258 and 259 may not be exercised within the framework of paragraphs 1 to 9 of this Article.’

\footnote{2915} Dashwood, 'The limits of European Community powers' (1996) 116: subsidiarity and proportionality ‘are principles controlling the exercise of Community powers; whereas the attribution principle goes to the question of the existence and extent of such powers.’

\footnote{2916} Menéndez (2014), 133.
under the twenty-one paragraphs of Articles 121 and 126 TFEU, there is only one fiscal obligation and one legal sanction: Under the Excessive Deficit Procedure, Member States must comply with the 3% of GDP deficit limits and 60% of GDP debt limit in Article 126(2)(a) TFEU, or, under Article 126(11) TFEU, they may be fined by up to 0.5% of GDP by their fellows voting in the Council by ordinary QMV.

No longer. The amendments to the corrective arm of the SGP under the ‘six pack’, ‘two pack’ and TSCG have made three significant changes to this framework:

Firstly, as shown in Section 8.1, sanctions now accompany: the declaration of ‘no effective action’ for deviation from the MTO (Article 121(4) TFEU); the declaration of the excessive deficit under Article 126(5) TFEU; the finding of an excessive imbalance (Article 126(5) TFEU); the corrective action plan and the decision of ‘non-compliance’ under the EIP (Article 126(8) TFEU); the decision of ‘no effective action’ under the EDP (Article 126(8) TFEU); and, finally, the sanctions of 0.5% of GDP for breach of the 3% deficit and 60% debt limits (Article 126(11) TFEU). It should be noted that, lattermost instance excepting, all of these fines are for something other than the debt limits in the Treaty. They penalise the failure to respond to the MTO or recommendations, and they levy costs which are not written anywhere in Articles 121 or 126 TFEU.

Secondly, under Regulations 1173/2011 and 1174/2011, all of these fines (Article 126(11) TFEU excepting) are adopted automatically unless rejected by RQMV defined in accordance with Article 238(3)(b) TFEU, which requires 72% of the Member States comprising at least 65% of the population to reject the proposal. This reverse ‘super’ QMV formula now applies to: the decision to require a lodgement of 0.2% of GDP upon the decision of ‘no effective action’ under the MSP; the decision to require a lodgement of 0.2% of GDP upon the activation of the EDP; the decision

2917 The commission shall immediately recommend that the Council adopt, by QMV, a decision and recommendation establishing ‘no effective action.’ If this is not so adopted within one month, the Commission will issue a second recommendation that is adopted automatically unless the Council votes by reverse ‘super’ QMV to reject it: Arts 6(2), 10(2) Reg 1466/97. Arts 4 and 5 of Reg 1173/2011 state that the Commission shall recommend, within 20 days of the decision of ‘no effective action’, the adoption of a Council decision requiring an interest-bearing deposit of 0.2% of GDP.

2918 If the Commission finds ‘particularly serious non-compliance’ with the obligations of the SGP, or if the country has already been fined under the preventative arm of the MSP, the Commission will recommend that the Council, by a further decision, require a non-interest-bearing deposit of 0.2% of GDP: Article 5(1),(2)-(4) Reg 1173/2011.

2919 Under the EIP, if two corrective action plans are rejected in the same EIP, the Commission will, within 20 days, recommend that the Council issue a decision impose an annual fine of 0.1% of GDP: Article 3(2)(a) Reg 1174/2011.

2920 Article 3(1) of Reg 1174/2011 states that the Commission will recommend the imposition of an interest-bearing deposit of 0.1% of GDP on the bases that the Member State ‘has not taken the corrective action recommended by the Council.’

2921 Arts 4 and 5 of Reg 1173/2011 state that the Commission shall recommend, within 20 days of the decision of ‘no effective action’, the adoption of a Council decision requiring an interest-bearing deposit of 0.2% of GDP. Article 4(1), 5 Reg 1173/2011. Some specifics on the use of fines is set out in Arts 8-10 Reg 1173/2011.

2922 MSP: Article 4 Reg 1173/2011. EDP: Article 5 Reg 1173/2011. EIP: Article 5 Reg 1175/2011. Under Arts 12(2) of Reg 1173/2011 and 5(2) of Reg 1174/2011, a QMV is defined in accordance with Article 238(3)(b) TFEU, which requires a ‘super’-QMV of 72% of the Member States comprising at least 65% of the population.

2923 Article 4(1), 5 Reg 1173/2011.

2924 Article 4(1), 5 Reg 1173/2011.
to impose a fine for ‘no effective action’ under the EDP;\textsuperscript{2925} the decision to require a lodgement or fine of 0.1% of GDP for failing to take ‘the corrective action recommended by the Council’ and for failure to submit a CAP.\textsuperscript{2926}

However, as Reg 1173/2013 cannot amend the Treaty, the decisions on the existence of an excessive deficit (Article 126(6) TFEU), the decision on ‘no effective action’ (Article 126(8) TFEU), and the decisions to sanction under Article 126(11) TFEU are still taken in accordance with ordinary Q MV under Article 126(12) TEU under EU law. Thus, while the new sanctions under the ‘six pack’ are virtually automatic, each is preceded by a QMV ‘gateway’ in the Council. In principle, if one looks to these gateway voting rules in the Treaty, no sanctions or budget recommendations should be possible without the active support of 55% of the Member States with 65% of the population.

Thirdly, however, this is where Article 7 TSCG, formed outside the Treaties by intergovernmental method, intervenes to usurp the voting rules in the Treaty. That article requires signatories to ‘commit to supporting the proposals or recommendations’ submitted by the Commission in the context of the EDP ‘unless a qualified majority of them are opposed.’ This effectively ‘switches’ all of the remaining gateways under the EDP: RQ MV now applies to the decision on the existence of an excessive deficit (Article 126(6) TFEU), the decision on ‘no effective action’ (Article 126(8) TFEU), the decision to give notice (Article 126(9)), and all of the decisions to sanction (Article 126(11) TFEU).\textsuperscript{2927}

The effect of the new framework is that that, while the Commission has no competence in economic policy, under 2-(2-a(3) (CSRs), 6(2) of Reg 1466/97 and Regs 1173-1174/2011, the Commission is, ‘as a rule,’ presumed to be able enumerate a detailed list of economic policy measures and sanction Member States who do not comply under reverse-QMV. Since any sanctions on the composition of the budget are, in effect, sanctions on the composition of policy choices, these recommendations have direct implications for elected choices taken within areas of national competence.\textsuperscript{2928} The issue for this section is whether this constitutes a violation of restriction of budgetary sovereignty under the test set out in Section 1.3.1.4 of this thesis.

\textbf{8.3.4.1 The Application of Reverse ‘Super’ QMV}

The effect of introducing reverse ‘super’ QMV into this paradigm has been carefully and illuminatingly documented by Van Aken and Artige.\textsuperscript{2929} In particular, this thesis focuses on two effects. First and most obviously, as RQ MV is defined in accordance with Article 238(3)(b) TFEU (72% of the Member States comprising 65% of the population), the support needed for the

\textsuperscript{2925} Art 6(2), 8(2) Reg 1173/2011.
\textsuperscript{2926} Article 3 Reg 1174/2011.
\textsuperscript{2927} As well as all the sanctions provided in Arts 4, 5, 6 and 8 Reg 1173/2011.
\textsuperscript{2928} De Streele (2014), 92: although recommendations are not legally binding \textit{stricto sensu}, they do ‘have indirect binding effect as their violation may lead to an investigation by the Commission and the imposition of sanctions by the Council.’
\textsuperscript{2929} Van Aken and Artige (2013).
Commission to pass its policies or sanctions is lowered considerably - from 11 countries (55.55%) and 66% of the population, to 3 countries and 35.1% of the population.\textsuperscript{2930} This allows the Commission to pass a recommendation against either a numerical super majority of up to 16 states,\textsuperscript{2931} or a population majority of 93.61%,\textsuperscript{2932} so long as either are offset by a minimum of three abstainers representing 35+1% of the population.

The second effect is that abstentions effectively count as ‘yes’ votes.\textsuperscript{2933} The Commission can pass legislation in the face of an overwhelming population or numerical majority with zero votes of support. For example, it is theoretically possible for the Commission to sanction Portugal or Greece in a vote opposed by 93.61% of the population from 9 countries, abstained by 6.39% of the population from 9 countries, and in which exactly 0 countries and 0% of the population vote in favour.\textsuperscript{2934} It is also possible for the Commission to sanction a country with zero countries voting in favour against a numerical majority of fifteen countries, so long as two large countries (35% of the population combined) + one small country abstain.\textsuperscript{2935}

In all cases, the Commission can sanction a Member State against an overwhelming numerical and demographic opposition of Europe’s Member States and citizens. This does not seem to adhere to the most basic principles of democratic accountability, let alone the Community method. As the BVerfGE has pointed out:

‘All systems of representative democracy have this in common: a will of the majority that has come about freely and taking due account of equality is formed, either in the constituency or in the assembly which has come into being proportionally, by the act of voting.’\textsuperscript{2936}

\textbf{8.3.4.2 Assessment: A Challenge to the Community Method, but not the EU Legal Order}

Under the ‘community method,’ according to the formula for representative democracy in Article 10 TEU, the legitimation for the exercise of Union competences is provided by the citizens both directly, through the European Parliament; and indirectly, through national governments accountable to national parliaments via the Council.\textsuperscript{2937}

\textsuperscript{2930} Art 12(2) Reg 1173/2011; 5(2) Reg 1174/2011; Art 7 TSCG.
\textsuperscript{2931} Author’s calculations. This scenario sees AT, BE, CY, EE, FI, FR, IE, LV, LT, LU, NL, PT, GR, SL, and SL (16 countries with 63.68% of the population) opposed.
\textsuperscript{2932} Author’s calculations. This scenario sees AT, BE, FR, GE, GR, IE, IT, NE, and ES (93.51% of the population) opposed.
\textsuperscript{2933} Van Aken and Artigue (2013).
\textsuperscript{2934} This example imagines AT, BE, FR, GE, GR, IE, IT, NE and ES (93.51% of the population) opposed and CY, ES, FI, LV, LT, LU, SK, SL and MT (6.39% of the population) abstaining.
\textsuperscript{2935} Assuming that the decision is a decision on sanctions or recommendations and therefore the state subject to the motion does not participate. The numerical majority can climb to 16 if it concerns the decision finding an excessive deficit.
\textsuperscript{2936} Re Lisbon (Germany) [191].
\textsuperscript{2937} Art 10 TEU states that the Union is founded on the principle of democracy, and this is predicated on the representations of the citizens at Union level in the European Parliament, and in the Council, themselves democratically accountable either to their citizens or their parliaments.
However, the European Parliament has no legislative role in the EDP and exerts no decision-making influence on the recommendations and sanctions proposed by the Commission and adopted by the Council.\textsuperscript{2938} As Chalmers observes, ‘The Parliament exercises no leverage over any of these institutions other than the Commission. There is no possibility for its views to feed back into the process…’\textsuperscript{2939} This leaves the Council. According to the Commission, this is where institutional responsibility for the policy outputs of the governance framework lies. In its fact sheet on the EDP, it states:

‘Member States are accountable to their EU counterparts, as they make a political commitment by endorsing the recommendations at EU leaders’ level and formally approving them at ministerial level. […] The recommendations presented by the Commission … are recommendations for the Council of Ministers to adopt, so it is the Council which has the final say.’\textsuperscript{2940}

But this is hardly congenial. First and most obviously, the Commission can now issue an autonomous recommendation with its own policies directly to a Member State under Article 11(2) Reg 473/2013 without any involvement from the Council,\textsuperscript{2941} and, as shown in Section 8.2.2 this recommendation then acquires legal force under Reg 473/2013.

Second, under EU secondary law and the TSCG, all decisions establishing ‘no effective action’ and activating sanctions are deemed to be adopted automatically unless the Council decides to the contrary by reverse-QMV within ten days. Under the EDP, this now applies to all stages of the recommendation and sanctioning procedure - including the design of recommendations. This would appear to constitute a manifest breach of the formula for representative democracy under the ‘community’ method.

However, this section finds that this does not infringe on Member State fiscal sovereignty or constitute an ultra vires act. This is so for two reasons. First, as shown in Section 1.3.1.4, the test for an unlawful restriction of fiscal sovereignty is that the restriction is not reversible by an equivalent act of the parliament in the future. In that regard, Reg 1173/2011 does not interfere with QMV control over the activation of the EDP because, as noted above, each stage is preceded by a QMV

\textsuperscript{2938} The only provision for the European Parliament throughout the European Semester is in the context of the ‘Economic Dialogues,’ in which European Parliament may ‘invite’ the Council or Commission to discuss various decisions taken in the context of the European Semester. However, as there is no duty to consult, the European Parliament remains thoroughly that of an informed spectator, not a legislator. See: Art 2-ab Reg 1466/97 (re: information, guidance, conclusions, and recommendations drawn by the Commission, Art 3 Reg 1173/2011 (re: sanctions and fines under the MSP and EDP); Art 2a Reg 1467/97 (re: all stages of the EDP).

\textsuperscript{2939} Chalmers (2012), 692. See also: Menéndez (2014), 134 ‘[T]he European Parliament has been assigned no substantive powers in the reformed European “economic governance”… the European Parliament has been confined to being the “lieu” where “economic dialogue” will take place.’


\textsuperscript{2941} Art 11(2) Reg 473/2013.
The real culprit here is Article 7 TSCG – an intergovernmental Treaty.

This has led some scholars to argue that Article 7 TSCG constitutes a circumvention or amendment of Article 126 TFEU in violation of the amendment procedures in Article 48 TEU. However, this thesis notes that there is no legal enforcement provision in the TSCG for any obligation outside of Article 3(2) (so the only penalty is reciprocity for the voting provisions), and Article 126 TFEU does not place any restrictions on how Council members vote. Article 7 TSCG does not, therefore, amend the Treaty. Instead, it professes to bind Member States outside the council, to vote accordingly once they enter it. This is an instrument of international law, enforced only by reciprocity. Whether this amounts to a ‘fetter’ on ministerial discretion in the Council is a matter of national constitutional orders. There is nothing under EU law to prevent a Member State from fettering its own Minister’s discretion to its own parliament or anything else. It is accepted that the practical reality is certainly the same: Reverse-QMV now applies to all stages of the EDP – a procedure which was drafted as a political, not legal, sanctioning mechanism. This would appear to usurp the community method. However, as an intergovernmental treaty, it is unilaterally reversible by an act of parliament, and so does not infringe fiscal sovereignty.

Second, as shown in Section 1.3.1.6, in order to constitute a violation of fiscal sovereignty the restriction on the budgetary powers of the parliament but be not ‘merely restricted’, but ‘effectively non-existent’ for ‘at least a considerable period of time’ In , budget commitments of €190,024,800,000 (approximately 50% of all central government expenditure) did not exceed this ceiling because it did not deprive the Bundestag of the ability to shape the economic and social life of the state. By that standard, signing-up to fines of up to 0.5% of GDP simply fall within the margin of appreciation afforded to the legislator by even the most assertive Member State constitutional court.

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2942 See, e.g., Craig, 'Stability, Coordination and Governance Treaty' (2012). See also: Dashwood, 'UK in a re-formed Union' (2013), 744, arguing that ‘such an obligation seems impossible to reconcile with the language of Art 126,’ which indicates that the power conferred on the Council to determine whether there is an excessive deficit is discretionary, and therefore cannot be fettered without violating the Treaty. Cf: Calleiss (2012), 108.

2943 There is no provision in the TSCG for any justiciable obligation outside of Article 3(2) TSCG.

2944 Roberto Baratta, 'Legal issues of the “Fiscal Compact” Searching for a Mature Democratic Governance of the Euro' in Bruno De Witte, Adrienne Heritier, Alexander H Treschel (eds), The Euro Crisis and the State of European Democracy (European University Institute) 2013) 31, 52.

2945 So, for example, the BVerfGE recently enforced structural accountability of German Ministers in the Council to the Bundestag as a vital part of German constitutional democracy: Parliamentary Rights to Information (ESM and Euro Plus Pact) (Germany) (Case 2 BvE 4/11): BVerfGE 131, 151.

2946 Re ESM II (Germany) [174], [184]

2947 Re ESM I (Germany) [240]; Re ESM II (Germany) [185]. Central government expenditure in 2012 was approximately €381bn in 2012. Eurostat, 'Government revenue, expenditure and main aggregates (gov_a_main)' (2014).
8.3.5 Conclusion: Three Manifest Infringements of Member State Fiscal Sovereignty

This section finds that fully three out of the four fiscal government mechanism examined in this sub-heading 8.3 explicitly or implicitly violate a Member State ‘ultra vires’ or ‘constitutional identity’ ruling in this thesis. In particular, remarkably, Regulation 473/2013, has op-opted the Member State TSCG in a matter which explicitly violates three separate rulings by three separate constitutional courts as to what constitutes a manifest breach of fiscal sovereignty - despite these rulings being delivered less than a year before its enactment. This conclusion is extracted as follows:

[8.3.1] First, as a result of Articles 3, 4(1) and 6(1) of Reg 473/2013, it is the value produced by the Commission and the Council under Articles 5(1) and 9(1) Reg 1466/97 – not the assessment of the Member State - which defines the appropriate MTO adjustment path towards it for the purposes of Directive 2011/85/EU;\(^{2948}\) budgetary processes, fiscal plans (SCPs), and draft budgets under Reg 473/2013;\(^{2949}\) and fiscal rules under Articles 3(1)(b) TSCG and 5(2)(a) of Reg 473/2013.\(^ {2950}\)

[8.3.2] Second, Article 5(2)(a) of Reg 473 spans the boundary between legal orders and co-opts the Fiscal Compact, inserting the Commission’s determination under Article 6(2) Reg 1466/97 into an intergovernmental Treaty that binds Member State constitutional law. This violates the explicit terms of the decision of the BVerfGE in \textit{Re ESM II (Germany)},\(^ {2951}\) the decision of the \textit{Conseil Constitutionnel} in \textit{Re TSCG (France)},\(^ {2952}\) and it exceeds the decisions of the VfGH in \textit{TSCG (Austria)} and \textit{Re ESM (Austria)} as to what falls ‘within the democratic parliamentary system foreseen by the Federal Constitutional Act.’\(^ {2953}\)

[8.3.3] Third, by professing a legal competence to enact legislation for Member State budgetary legislation to ensure ‘uniform compliance with budgetary discipline,’ Directive 2011/85/EU constitutes an \textit{ultra vires} breach going to the core of budgetary sovereignty.\(^ {2954}\) There is no competence to amend national budgetary laws so that the 3% or 60% debt values - plus a third variable, the MTO, found nowhere in the Treaty - take effect in national law. The unavoidable conclusion is that Directive 2011/85/EU cannot be binding in the Member States, and in so far as it is binding, is \textit{ultra vires} EU law.

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\(^{2948}\) Arts 4-5, 9-14 Directive 2011/85/EU.

\(^{2949}\) Arts 4, 4(1), 6(1) Reg 473/2011.

\(^{2950}\) See Section 8.3.2.

\(^{2951}\) \textit{Re ESM II (Germany)}, [164], [168], [173], [242]-[245].

\(^{2952}\) \textit{TSCG (France)}.

\(^{2953}\) (And so may take effect without a total revision (\textit{Gesamtänderung}) procedure under Article 44(3) of the Constitution) \textit{TSCG (Austria)} [80]-[82]. Press release in English: Verfassungsgerichtshof Österreichischer, 'Fiscal Compact not held unconstitutional' (5 November 2013). In \textit{ESM (Austria)} the VfGH upheld the ratification of the ESM Treaty under Art 9(2) as being sufficiently ‘specific and limited’ because it provided for a capped amount of financial contribution. \textit{A contrario}, it means that such an open-ended commitment would be unconstitutional if conferred on a body other than the EU.

\(^{2954}\) Rec 28, Directive 2011/85/EU.
[8.3.4] The reverse ‘super’ QMV procedures would appear to constitute an evasion of the ‘community’ method, however the test for an unlawful restriction of fiscal sovereignty Section 1.3.1.4 is not met because it is the TSCG which intercedes in the TFEU voting procedures. Furthermore the consequences – fines of up to 0.5% of GDP - do not restrict fiscal sovereignty according to the test set out in Section 1.3.1.6 of this thesis.

8.4 Binding Vertical Interlinkages with EU Macroeconomic Governance

This fourth section of this chapter is concerned with binding, EU-legislated, vertical interlinkages between national legal orders and macroeconomic recommendations issued in the context of the EU’s MIP/EIP procedure. 2955 The preventative arm, the ‘Macroeconomic Imbalance Procedure’ (MIP) enacted under Article 121(6) TFEU, establishes a ‘macroeconomic scoreboard’ in order to identify macroeconomic imbalances. The corrective arm, the ‘Excessive Imbalance Procedure’ (EIP) enacted under Article 126(12) TFEU, contains a new sanctioning mechanism (for EMU countries) tilted towards the Commission under the ‘super’ reverse-QMV procedure examined in the preceding section. 2956

As economic policy recommendations are adopted on the basis of Articles 121(2) and (4) TFEU, this is not problematic in so far as, as a matter of EU law, these recommendations are not binding. As Dawson explains:

‘So long as CSRs are simply “recommendations”, their legal effects, and therefore their capacity to override limits prescribed in EU/national constitutional orders, is limited… The ‘soft’ coordination of national policies at the European level is justified so long as it operates parallel to, rather than supplants, the ordinary legislative process.’ 2957

However, under the constellation of binding interlinkages examined in this section, the CSRs are not merely advisory, and no longer operate parallel to the ordinary legislative process. Highly-specific, sanction-backed economic policy recommendations are now woven into a web of binding secondary EU legislation that binds Member States ‘in areas specifically excluded from EU interference by the Treaty.’ 2958 This section investigates three aspects of this procedure:

[8.4.1] First, under Articles 4 -5 of Reg 1176/2011, the Commission has a virtually-unlimited discretion to choose the macroeconomic variables which will be included in the macroeconomic scoreboard (as well as how they are applied), and therefore the competences for which Member

2955 The MIP/EIP was introduced under the ‘six pack’ to provide a ‘structured mechanism for the surveillance of harmful macroeconomic imbalances and their correction in all Member States.’ Commission, ‘Enhancing economic policy coordination’ COM(2010) 367 final, 3.
2956 The recitals to Reg 1174/2011 state that the procedure for applying sanctions ‘should be construed in such a way that the application of sanctions to those Member States would be the rule and not the exception.’
2958 Dawson and de Witte (2013), 840.
States may be brought under the system of co-government.\textsuperscript{2959} The Commission is able to determine the scope of the AMR, determine the thresholds and criteria for IDR\textsc{s} without limit, and issue recommendations which the Council is bound to, ‘as a rule’ accept under reverse ‘super’ QMV.

[8.4.2] Second, the definition of ‘imbalances’ and ‘excessive imbalances’ under Article 2 of Reg 1176/2011 are not restricted to the scope of the EU’s legislative competence, they are not limited to cross-border situations, and they are not limited to the stability of the monetary union.

[8.4.3] Third, as shown above in Section 8.2.2, Articles 3(3), 4(1) and 6(2) of Reg 473/2013 state that EMU Member States’ budgetary procedures, medium-term fiscal plans, and draft budgets themselves ‘shall be consistent with,’ \textit{inter alia}: ‘the macroeconomic imbalances procedure as established by Regulation (EU) No 1176/2011.’\textsuperscript{2960} This, combined with a definition of ‘imbalances’ that extends to essentially \textit{any} economic situation in any Member State – even if there is no spillovers or overlap with any of the Union’s competences – has stretched a binding EU law obligation into Member States’ exclusive economic competences.

This section will demonstrate that this arrangement violates the test for unlawful dispositions of fiscal sovereignty under the constitutional identity jurisdiction in Section 1.3.1.5 of this thesis.

\subsection*{8.4.1 Component 1: The Scope of the Macroeconomic Scoreboard}

The MIP begins in January with the adoption of the Alert Mechanism Report (AMR), which evaluates national economies against a macroeconomic ‘scoreboard’ consisting of 14 headline variables and 25 auxiliary indicators designed to indicate both internal and external imbalances.\textsuperscript{2961} Seven indicators relate to internal imbalances,\textsuperscript{2962} seven relate to external imbalances,\textsuperscript{2963} and the scoreboard has expanded over time.\textsuperscript{2964} Those states flagged by the AMR will then be subject to

\textsuperscript{2959} For a deep analysis on this point, see: Chalmers (2012).
\textsuperscript{2960} Arts 3(3), 4(1), 6(1) Reg 473/2013.
\textsuperscript{2961} Established by Arts 3, 4 Reg 1176/2011, under Art 121(2) TFEU. See also: European Commission, ‘Scoreboard ’ (2012); Commission, ‘Financial Sector Indicator 2011’ SWD(2012) 389 final; European Council Conclusions on an early warning scoreboard for the surveillance for macroeconomic imbalances (Brussels, 8 November 2011) 157981/2/11 Rev 2.
\textsuperscript{2962} Specifically: Private sector credit flows (% of GDP) with a threshold of 14%; year-on-year changes in house prices relative to a Eurostat consumption deflator, with a threshold of 6%; 60% GDP general govt\textsc{'} debt; 3-year backward moving avg of unemployment rate, with a threshold of 10%; year-on-year changes in total financial sector liabilities, with a threshold of 16.5%; 3-year change in p.p. of the activity rate, with a threshold of -0.2%; 3-year change in p.p. of long-term unemployment, with a threshold of +0.5%; and 3-year change in p.p. of youth unemployment, with a threshold of +2%.
\textsuperscript{2963} Specifically: 3-year backward moving average of the current account balance as percent of GDP, with thresholds of +6% and -4%; net international investment position as percent of GDP, with a threshold of -35%; 5-year percentage change of export market shares measured in values, with a threshold of -6%; 3-year percentage change in nominal unit labour cost, with thresholds of +9% for euro area countries and +12% for non-euro area countries; 3-year percentage change of the real effective exchange rates based on HICP/CPI deflators, relative to 41 other industrial countries, with thresholds of -/+5% for euro area countries and -/+11% for non-euro area countries; and private sector debt (consolidated) in % of GDP with a threshold of 133%.
\textsuperscript{2964} In 2011, the initial scoreboard had 10 indicators. 2012 added an indicator for the financial sector, and 2015 saw the addition of the employment activity rate, long-term unemployment, and youth unemployment: Alert Mechanism Report 2016.
further in-depth reviews (IDRs) by the Commission to determine whether they are affected by imbalances or excessive imbalances.2965

Of primary concern to this section is the remarkable discretion afforded to the Commission to choose the economic variables and analytical tools by which Member State competences may be brought under the system of co-government. In that regard, the legislative basis for the macroeconomic scoreboard is Articles 4 of Reg 1176/2011, which establishes its parameters as follows:

‘(3) The scoreboard shall, inter alia, encompass indicators which are useful in the early identification of:

(a) internal imbalances, including … public and private indebtedness; financial and asset market developments, including housing; the evolution of private sector credit flow; and the evolution of unemployment;

(b) external imbalances, including … the current account and net investment positions of Member States; [REER]; export market shares; changes in price and cost developments; and non-price competitiveness, taking into account the different components of productivity.’

Two things must be noted about this paragraph. First, it should be noted that Article 4(3) does not legislate the scoreboard itself. The task of drafting the scoreboard belongs to the Commission under Article 4(7) which states:

‘(7) The Commission shall assess the appropriateness of the scoreboard, including the composition of the indicators, the thresholds set and the methodology used, and it shall adjust or modify them where necessary. The Commission shall make changes in the underlying methodology and composition of the scoreboard and the associated thresholds public.’

Second, the only substantive limitation on this discretion is that the scoreboard should include, at minimum, the open list of variables in Article 4(3).2966 Outside of this, there is no system of institutional oversight or accountability in the design of the scoreboard, and no limits on the exercise of the Commission’s discretion whatsoever.2967

And yet, once an indicator has been introduced to the scoreboard, the AMR will bring that area within the reach of the ‘hard law’ constraints of the MIP, and the Member States will receive recommendations in that context - even if it concerns an exclusive competence which has no effect on the Union’s competences. Accountability issues almost immediately. The European Parliament’s first review of the Commission scoreboard, for example:-

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2965 Art 3(3) Reg 1173/2011; 5 Reg 1176/2011.
2966 The only other criteria is that any other indicators be ‘relevant, practical, simple, measurable and available’: Art 4(2) Reg 1176/2011.
2967 The only obligation is an obligation to ‘consult’ the ESRB on any financial indicators: Art 4(5) Reg 1176/2011.
‘Notes that the Commission working document cites the “available economic literature” without providing a single specific reference; calls on the Commission to provide a more complete explanation of its methodological approach, including the different options envisaged, along with a comprehensive bibliography as background to the scoreboard.’

The macroeconomic scoreboard has since expanded outwards to encompass a list of indicators that bears no resemblance to the Union’s legislative competences. The ten headline indicators and eighteen auxiliary indicators of the first macroeconomic scoreboard in February 2012 were confined to those set out in Articles 4(3) of the regulation. In November 2012, an eleventh indicator relating to financial sector liabilities was added, at which time the Commission assured that it ‘does not foresee the addition of new indicators to the scoreboard.’ Then, less than a year later, the Commission introduced eight social indicators to the auxiliary list, despite noting that ‘employment and social policies fall very largely under the national competence of the Member States.’ In 2015, the Commission then moved three of these social indicators - the activity rate, long-term unemployment, and youth unemployment - to the headline scoreboard. As the Commission appeared to acknowledge in 2015, it had clearly broken from the scope and rationale of the legislative basis for the MIP:

‘The inclusion of these variables into the scoreboard shall not have legal implications nor change the focus of the MIP, which remains aimed at preventing the emergence of harmful macroeconomic imbalance and ensuring their correction. To this purpose, no additional employment and social indicators should a priori be added to the scoreboard in the future.’

Yet the very next month, in October 2015, Commission meeting minutes showed the enunciation a new, ‘highly political’ strategy to add more social indicators to the MIP, such as ‘access to healthcare and the level of social protection,’ proposing that ‘reference criteria be set to measure those

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2969 Primary indicators consisted of: The net international investment position, the REER, export market shares, nominal unit labour cost, deflated house prices, private-sector credit flow, private-sector debt, general government debt, and the unemployment rate. Secondary indicators were as follows: Real GDP growth, gross fixed capital formation, gross domestic expenditure on R&D, the current account balance, net borrowing/lending, net external debt, FDI inflows, net trade balance, REER vs EA(17), labour productivity, employment, nominal ULC, effective ULC vs EA(17), nominal house prices, residential construction, and financial liabilities. European Commission, Alert Mechanism Report COM(2012) 68 final, 3.
2971 These included: The activity rate (ages 15-64), youth unemployment, young people not in employment, education or training, people at risk of poverty or social exclusion, at-risk poverty rates, the severe material deprivation rate, and persons living in households with very low work intensity. European Commission, ‘Strengthening the Social Dimension of the Economic and Monetary Union’ COM(2013) 690 final, 4 (emphasis added); Alert Mechanism Report 2014.
2973 Commission, Employment indicators (2015), 1,
The stated objective for this was not the stability of the monetary union, but - ‘to rally the support of the people of Europe for the project of deepening EMU.’

It is hard to imagine this meeting any test of controlled delegation. To rally political support for deepening EMU is a far cry the objective of the EU’s coordination competence - which is, according to the regulation, ‘the prevention and correction of excessive macroeconomic imbalances within the Union’ for the ultimate purpose of price stability. Quite contrary to the Commission’s above statement that this has no legal effects, it must be recalled that the addition of this factor is not merely advisory - the AMR determines the scope for IDRs, and IDRs identify imbalances and inform recommendations, which are then enforced under EU and national law under the MIP and Reg 473/2013. In short, expands the scope of the entire system of co-government. As Chalmers observes, ‘the thresholds for determining when States enter and exit this sphere of co-government are very unstable: something which offends the very idea of limited government.

8.4.2 Component 2: ‘Imbalances’ and ‘Excessive Imbalances’

Those states flagged by the AMR will then be subject to further in-depth reviews (IDRs) by the Commission to determine whether they are affected by ‘imbalances’ or ‘excessive imbalances’. ‘Imbalances’ are defined as ‘any trend giving rise to macroeconomic developments which are adversely affecting, or have the potential adversely to affect, the proper functioning of the economy of a Member State or of the [EMU] or of the Union as a whole.’ ‘Excessive imbalances’ are ‘severe imbalances, including imbalances that jeopardise or risk jeopardising the proper functioning of the economic and monetary union.’

The contours of these definitions should be noted. The preventative arm explicitly refers to imbalances that affect the ‘functioning of the economy of a Member State’ individually, and the definition of ‘excessive imbalances’ is not confined to imbalances that ‘risk jeopardising the proper

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2976 Rec 9, Reg 1173/2011.
2977 Commission, Strengthening the Social Dimension COM(2013) 690 final, 4 itself states that ‘The [MIP] was introduced... to give EMU a surveillance mechanism for preventing and correcting serious imbalances, together with a means of enforcing it.’
2978 Chalmers (2012) 682-4 notes that the EDP and MIP procedures abound with such norms. Examples include: i) the discounting of certain headings of expenditure for the purposes of calculating whether a deficit is ‘excessive’ (Reg. 1467/97, Art 2(4)); ii) the discretion to declare a deficit in-excessive where it is declining substantially and continuously (Art 126(2)(a) TFEU); iii) the broad and limitless definition of an ‘excessive imbalance’ (which is taken to mean ‘any trend giving rise to macroeconomic developments which are adversely affecting... the proper functioning of the economy’) (Reg. 1176/2011, Art 2(1); and iv) the contested means by which an economy’s structural deficit can be counted. See also: Dawson, ‘Legal and Political Accountability Structure ’ (2015), 987; Menéndez (2014), 128.
2979 Art 5 Reg 1176/2011. This typically occurs in the first two months of the year, and the results are issued as part of the Country Reports at the beginning of the European Semester.
2980 Art 2(1) Reg 1176/2011.
functioning of the [EMU].’ In other words, the governance regime extends to virtually \textit{any} macroeconomic development within a Member State, even where such imbalances are purely internal to the Member State. Furthermore, Article 3(2) adds that ‘conclusions shall not be drawn from a mechanical reading of the scoreboard indicators,’ further muddying the waters further of what an ‘imbalance’ even is.\footnote{Menéndez (2014), 128 concludes: ‘The European Commission and the European Council have been decisively empowered to shape national economic policy. These two institutions have been granted new powers concerning the monitoring and control of national macroeconomic policy (Member States are now mandated to prevent and correct national macroeconomic imbalances).’}

Once the scoreboard ‘flashes,’ Article 5 of Reg 1176/2011 then gives the Commission a virtually open-ended mandate to examine the origin of the detected imbalances, potential spill-over effects, compliance with Council recommendations, the policy intentions of Member States, and any warnings from the ESRB.\footnote{The relevant parts Art 5 Reg 1176/2011 read: (1) ‘the Commission shall undertake an in-depth review for each Member State that it considers may be affected by, or may be at risk of being affected by, imbalances. The in-depth review shall build on a detailed analysis of country-specific circumstances, including the different starting positions across Member States; it shall examine a broad range of economic variables and involve the use of analytical tools and qualitative information of country-specific nature. It shall acknowledge the national specificities regarding industrial relations and social dialogue… (2) The Commission's in-depth review shall include an evaluation of whether the Member State in question is affected by imbalances, and of whether these imbalances constitute excessive imbalances. It shall examine the origin of the detected imbalances against the background of prevailing economic circumstances, including the deep trade and financial interlinks between Member States and the spill-over effects of national economic policies…. It shall also consider the relevance of economic developments in the Union and the euro area as a whole.’ It shall, in particular, take into account: (a) Any Council recommendations or invitations adopted under the framework; (b) Member State policy intensions and (c) input from the ESRB.} Article 5(1) goes so far as to include qualitative information - even where this information is country-specific in nature.\footnote{Art 5(2) Reg 1176/2011: ‘The in-depth review … shall examine a broad range of economic variables and involve the use of analytical tools and qualitative information of a country-specific nature.’}

This makes it nigh impossible to hold the Commission accountable for its assessments.\footnote{Dawson, 'Legal and Political Accountability STructure ' (2015), 987: ‘The broad and indeterminate nature of norms under EU economic governance makes it difficult, if not impossible, to legally scrutinize whether executive actors (i.e. the Commission) have ‘correctly’ or ‘incorrectly’ applied rules.’} AMRs are transmitted to the European Parliament, the Council and the EESC, but they have no amending role in the assessments.\footnote{Art 4(1) Reg 1176/2011; Art 6 Reg 1174/2011; Arts 3(9), 7(1),(4),(10), 18 Reg 472/2013; Arts 7(3), 15(1)-(3) Reg 473/2013.} Similarly, the only provision for the European Parliament is the Economic Dialogues, which do not begin until later stages of the MIP, and do not impact the reviews.\footnote{Under Article 3(4) Reg 1173/2011 the Council will adopt conclusions on the AMR, but has no amending role. Similarly, under Art 4(4) Reg 1175/2011, the Eurogroup shall ‘discuss’ the report, but has no ability to amend the content.} National parliaments, or course, are excluded entirely. Member States are represented at this stage only in the Council and the Eurogroup, which may adopt conclusions or ‘discuss’ the report, but have no ability to alter the content.\footnote{Not that such oversight would matter: The Commission can anyways make changes to the methodology and thresholds autonomously, and furthermore asserts}
that ‘there is no automatic or mechanical interpretation’ of the scoreboard, ‘but rather a qualitative assessment’.2989

8.4.3 Component 3: Economic Recommendations are Incorporated into Binding EU Law

Once a Member State’s economic policy has been brought under the system of co-government, it will receive detailed, sanctioned-backed policy recommendations in areas for which there is little doubt the Union has no competence to legislate.2990 If the IDR results in a finding of imbalances, the Council may adopt, by QMV, the Commission recommendation for corrective action under Article 121(2) TFEU.2991 If the IDR results in a finding of ‘excessive imbalances,’ EMU Member States must submit a ‘Corrective Action Plan’ (CAP) detailing the specific policy actions the Member State intends to implement which will be ‘based on, and within a deadline to be defined in’ the Council recommendation.2992 It should be recalled that, here again, the Member States are not free to devise their own solutions – both the EPP and the CAP must be based on EU recommendations.2993

These recommendations and programmes do not distinguish between policies fields in which the EU has some competence, such as internal market or energy policy, and those which would clearly be ultra vires at EU level (such as direct taxation).2994 Nor do they differentiate between those policies which fall under EU legislation, (such as fisheries) and those which do not (such as education).2995 They do not even differentiate between those with cross-border effects (such as foreign investment), and those that exclusively concern the internal organisation of the social state (such as the 2015 recommendation to the Netherlands to relocate social housing).2996 CSRs also seldom distinguish whether they are aimed at targeting the fiscal balance or whether they are attempting to fine-tuning


2990 Art 2 Reg 1176/2011. The UK’s 2015 CSR, for example, stretched risks related to the high level of household indebtedness into a recommendation on city planning policy: Council Recommendation of 14 July 2015 OJ C 272/26.

2991 The vote on a finding of excessive imbalances and all subsequent recommendations applying to that state under the EIP, are taken by QMV without the participation of the Member State concerned: Art 8(1) Reg 1176/2011.

2992 This is the economic-policy successor to the EPP and they are often the same document: the EPP will be merged within the CAP if both exist. See: Art 8(1) Reg 1176/2011; Art 9(5) Reg 473/2013 states.

2993 The CAP ‘shall be based on the Council’s recommendation’ and ‘shall be consistent with the broad economic policy guidelines’: Art 8(1) Reg 1176/2011. The EPP must ‘fully take into account the Council recommendations on the implementation of the integrated guidelines.’ Art 9(1)-2) Reg 473/2013.


the national economy. Nor do they contain any assessments of subsidiarity. Nor do Commission minutes show any internal awareness or concern for the limits of competence. In the same breath, Commission minutes propose ‘targeted measures to boost employment among vulnerable groups such as women, older workers and migrants,’ strategies for ‘plugging the gaps in social safety nets,’ and measures targeting ‘health care or in favour of children, in terms of early schooling and assistance.’ By 2016, Commission minutes expressed ‘satisfaction that, for example, question such as the pay gap between men and women’ ‘the efficiency of the judiciary,’ and ‘the quality of health care systems and access to good quality care’ had been deployed in the context of the European Semester. None of these policies are within the legislative competences of the Union.

Thus, recommendations which would, if found to create legal effects be demonstrably outside the competences of the Union, often directly lead to highly-specific and expansive legislative programmes in national law. Ireland and Italy’s CSRs from 2011-2015, for example, specify legislation for employment protection and dismissal rules; child and elderly care, reducing court docket backlogs, vocational training for youth, school evaluation, the tax wedge on labour, and contain specific recommendations to enact specific instruments of legislation. The Commission has even penned and supervised sprawling, intensive, legislative timelines for Member States.

As economic policy recommendations are adopted on the basis of Articles 121(2) and (4) TFEU, this is not problematic in so far as, under Article 288 TFEU, even a clear, precise and unconditional recommendation will not be capable of legal effect. However, as the ECJ ruled in Germany, France,

All CSRs include the following caveat: ‘In order to take account of their interlinkages, the two programmes [economic NRPs and fiscal SCPs] have been assessed at the same time.’ See, e.g., Council Recommendation of 14 July 2015 on the 2015 National reform Programme of Italy [2015] OJ C 272/16, at (6).

Internal Commission meeting minutes show that the Commission interprets the ‘two pack’ to mean that national budgets and economic policies ‘would from now on be regarded as issues of common European interest’: European Commission, Minutes of the 2107th meeting of the Commission held in Strasbourg (Winston Churchill) on Tuesday 26 November 2014 PV(2014) 2107 final, 32, per Commissioner Dombrovskis.


E.g., Council Recommendation of 8 July 2014 on the NRP of Italy [2014] OJ C 247/11 admonishes Italy to ‘adopt the legislative decrees, on the use of wage supplementation schemes, the revision of contractual arrangements, [and] work-life balance.’

See the list of legislation in the Intermediate Report on the implementation of Italy’s CSRs and the legislative monitor attached to: Italy, Draft Budgetary Plan (Ministero Dell’Economia e Delle Finanze, 2015). See also: European Commission Recommendations for a Council recommendation on the 2014 National Reform Programme of Ireland and delivering a Council opinion on the 2015 Stability Programme of Ireland COM(2014) 408 final, complaining that specific policy measures can be changed by the government when decisions on the budget are made.
the Netherlands, Denmark and the UK v Commission,\textsuperscript{3009} and Grimaldi,\textsuperscript{3010} a recommendation can be imbued with legal force through incorporation into binding EU law. Herein the problem once again lies. Once the economic policy recommendations under the MIP have been folded into the annual cycle of surveillance, Articles 3(3), 4(1) and 6(2) of Reg 473/2013 state that Euro Member States budgetary procedures (Article 3), medium-term fiscal plans (SCPs) (Article 4(1)), and draft budgets themselves (Article 6(1)) ‘shall be consistent with,’ \textit{inter alia}:

‘recommendations issued in the context of the annual cycle of surveillance, \textit{including the macroeconomic imbalances procedure as established by Regulation (EU) No 1176/2011}.’\textsuperscript{3011}

As shown above, according to Ledra v Commission and Council, this requires nothing less than ‘compatibility and non-contradiction between them,’\textsuperscript{3012} and constitutes a binding obligation to refrain legislating an economic programme ‘whose consistency with EU law [one] doubts.’\textsuperscript{3013}

Under Articles 3(1) and 10(4) of Reg 1174/2011, the Council will issue a decision establishing ‘non-compliance’ if, in the Commission’s view, the Member State ‘has not taken the corrective action \textit{recommended by the Council}.’\textsuperscript{3014} In that regard, Article 3(1) states:

‘An interest-bearing deposit shall be imposed by a Council decision, acting on a recommendation from the Commission, if a Council decision establishing non-compliance is adopted in accordance with Article 10(4) of Regulation (EU) No 1176/2011, where the Council concludes that the Member State concerned \textit{has not taken the corrective action recommended by the Council}.’\textsuperscript{3015}

This raises the possibility that Member States will be in breach of the legal duty under Articles 3, 4, and 6 of Reg 473/2013 where, in the Commission’s view, they wish to risk the financial stability of their own country and no others; or where they are not at risk, but simply in non-compliance with the specific policies issued by the Union. As shown in Section 8.2.2, an economic policy plan that has been held in ‘non-compliance’ under Article 3(1) and 10(4) of Reg 1174/2011, or ‘particularly serious non-compliance’ under Article 7(1) of Reg 473/2013 can hardly be said to conform to the binding obligation in Articles 3(3), 4(1) and 6(1) of Reg 473/2013. It must further be recalled that, as Recital 20 of Reg 473/2013 explains, that the concept of ‘particularly serious non-compliance’

\textsuperscript{3009} Joined Cases 281, 283-285, 287/85 \textit{Germany, France, the Netherlands, Denmark and the UK v Commission.}

\textsuperscript{3010} Grimaldi [18]-[19].

\textsuperscript{3011} Arts 3(3), 4(1), 6(1) Reg 473/2013. This encompasses, but is not limited to, any and all recommendations issued under Regulations 1176./2011, 1466/97, 1467/97 and 473/2013, or any others issued the context of the European Semester, including those which pertain to substantive Member State economic and social policies

\textsuperscript{3012} Ledra \textit{(Opinion of AG Wahl)} [72] (emphasis added).

\textsuperscript{3013} Case C-8-19/15P Ledra [58]-[60], [67].

\textsuperscript{3014} Article 3 Reg 1174/2011. This is deemed to have been adopted automatically by the Council unless it decides, by ‘super’ QMV, to reject the recommendation within ten days: Article 10(4) Reg 1176/2011.

\textsuperscript{3015} Art 3 Reg 1174/2011 (emphasis added). If two such decisions of non-compliance are adopted in the same procedure, the Commission will recommend that the Council convert the interest-bearing deposit into an annual fine of 0.1% of GDP: Art 10(4) Reg 1176/2011.
extends to any ‘where the implementation of the draft budgetary plan would put at risk the financial stability of the Member State concerned’ or ‘where the implementation of the draft budgetary plan would entail a violation of the recommendations adopted by the Council.’

This is much less than adherence to budgetary targets, which is much less than the stability of the euro area as a whole, which in turn is much less than monetary price stability (which is the only Union competence here).

8.4.4 Assessment: An Ultra Vires Disposition of Fiscal Sovereignty

This raises the prospect of a severe ultra vires breach driving to the core of fiscal sovereignty. As shown in Section 1.3.1, the principles of popular sovereignty and constitutional democracy (Article 20(2) BL) shielded by the ‘eternity clause’ (Article 79(3) BL) of the 1949 German Basic Law protects the entire ‘chain of legitimation’ between the voter (Article 38(2) BL) and the financial competences of an autonomous Bundestag, free of ‘other-directedness’ (Article 38(1) BL). This precludes any arrangement where financial liability is or exercised according to supranational accountability structures in which elections are neither free, direct or equal, and where the Bundestag does not have a ‘decisive influence’ over the result. In that regard, the test for constitutional identity which applies to such instruments is that set out in Section 1.3.1.5 - as the BVerfGE so put it in Aid Measures to Greece (Germany): a violation of the principle of democracy in its essential content will occur ‘if the German Bundestag relinquishes is parliamentary budget responsibility with the effect that it or a future Bundestag can no longer exercise the right to decide on the budget on its own responsibility.’ In Lisbon (Germany) the BVerfGE held:

‘The German Bundestag must decide, in an accountable manner vis-à-vis the people, on the total amount of the burdens placed on citizens. The same applies correspondingly to essential state expenditure... which citizens want to influence through free and equal elections. [...] What is decisive is that the overall responsibility, with sufficient political discretion regarding revenue and expenditure, can still rest with the German Bundestag.’

It is clear that the above arrangement does not meet this test. Those provisions which give legal effect to Commission and Council recommendations under Article 3, 4(1) and 6(1) of Reg 473/2013, upon the Opinions of ‘non-compliance’ under Articles 3 and 10(4) of Reg 1176/2011, or 7(1) of Reg 473/2013 necessarily violate the constitutional test identified in this thesis. For this reason, this framework must necessarily be ineffective, and in so far as it is effective, vulnerable to repudiation by Member State constitutional courts. The Portuguese Tribunal Constitucional has, for example,

3016 Rec 20 Reg 473/2013 (emphasis added).
3017 Re Lisbon (Germany) [228]; Aid Measures for Greece (Germany) [107], [127]; Re ESM I (Germany) [193]-[196]; Re ESM II (Germany) [161]; Gauweiler I (Germany) [28].
3018 Aid Measures for Greece (Germany) [121].
3019 Re Lisbon (Germany) [228]-[232]. See also: Aid [107], [127]; Re ESM I (Germany) [193]-[196]; Re ESM II (Germany) [161]; Gauweiler I (Germany) [28].
ably struck down numerous economic reforms enacted to comply with EU recommendations under this procedure - despite severally intimating that it believed it was invalidating economic reforms legislated under binding EU law.\textsuperscript{3020}

If macroeconomic surveillance is to perform a beneficial role in the fiscal framework, the prescription set out in Section 8.2.2 must be followed, and the machinery of the ‘budgetary veto’ must be dismantled. Until Articles 3 and 10(4) of Reg 1176/2011 are no longer triggers for binding legal consequences under the mechanism in Articles 3 4(1), 6(1) and 7(1) of Reg 473/2013, this framework will remain an economically ineffective and legally destabilising cog in European fiscal federalism.

### 8.5 Binding Interlinkages with ESM and EFSM Financial Conditionality

The final legal instruments of concern to this thesis are the macroeconomic adjustment programmes attached to EFSM and ESM financial assistance. These have taken various forms under various legal bases since the crisis. Recommendations are the main policy instrument used throughout the European semester, while evaluations of fiscal plans, draft budgets EPPS and CAPs (upon which ESM programmes are based)\textsuperscript{3021} take the form of opinions under Articles 121 and 126(5) TFEU.\textsuperscript{3022} Economic conditionality attached to EFSM financial assistance has been issued in the form of Council implementing decisions,\textsuperscript{3023} while ESM conditionality issued to Greece, Spain and Cyprus have taken the form of Council Decisions under Articles 126 and 136 TFEU.\textsuperscript{3024} *Sui generis* instruments have also been used at various junctures: Conditionality appears in Eurogroup statements and MoUs; the Commission has regularly engaged in written negotiations pursuant to its budgetary veto (see Section 8.2.2.3),\textsuperscript{3025} and the ECB President has admitted to sending ‘extraordinary’ letters

\textsuperscript{3020} See, e.g., Case C-264/12 *Sindicato Nacional dos Professionais de Seguros e Afins* (Order of 7 March 2013) [15] (Court reiterating its reference even after the CJEU rejected the first preliminary reference); Case C-665/13 *Sindicato Nacional dos Profissionais de Seguros e Afins* (Order of 21 October 2014), [10] (‘considering that a decision of the Court on the interpretation of the … Charter is necessary to enable it to rule on the dispute before it’”). See also: *Amendments to the Labour Code (Portugal)*; LOE2011 (Portugal); LOE2012 (Portugal); LOE2013 (Portugal); LOE2014 (Portugal).

\textsuperscript{3021} Art 7(1) Reg 472/2013 states: ‘Where a Member State requests financial assistance from one or several other Member States or third countries, the EFSM, the ESM, the EFSF or the IMF, it shall prepare, in agreement with the Commission, acting in liaison with the ECB and, where appropriate, with the IMF, a draft macroeconomic adjustment programme which shall build on and substitute any economic partnership programme under Regulation (EU) No 473/2013 and which shall include annual budgetary targets.’

\textsuperscript{3022} Arts 5(2), 9(2) Reg 1466/97; Art 7(1) Reg 473/2013.

\textsuperscript{3023} See e.g. Council Implementing Decision 2011/77/EU; Council Implementing Decision 2011/334/EU.


listing ‘economic, fiscal and structural measures’ to countries such as Ireland, Greece, Spain and Italy.

Financial conditionality has now been institutionalised under Regulation 472/2013 of the ‘two pack.’ As shown in Section 6.1.5, under Regulation 472/2013 (NB: an instrument of secondary EU law) the Commission is tasked with assessing requests for stability support (in hand with the ECB), negotiating and drafting economic conditionality (in hand with the ECB), ensuring that the ESM macroeconomic programme is enacted into EU law by the Council, and overseeing compliance under the EU’s economic governance procedures. Importantly, under Article 7(2) Reg 472/2013:

‘The Commission shall ensure that the [MoU] signed by the Commission on behalf of the ESM or the EFSF is fully consistent with the macroeconomic adjustment programme approved by the Council.’

Once agreed, the macroeconomic programmes are simultaneously duplicated in EU Council decisions or Council implementing decisions, and these decisions are binding under Article 288 TFEU. Monitoring and compliance is then conducted entirely through EU law and fed through the four legal regimes extracted above.

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3027 Art 6 Reg 472/2013: ‘Where a Member State requests financial assistance from the EFSM, the ESM, or the EFSF, the Commission shall assess, in liaison with the ECB and, where possible, with the IMF, the sustainability of that Member State’s government debt and its actual or potential financing needs. The Commission shall submit that assessment to the Eurogroup Working Group where the financial assistance is to be granted under the ESM or the EFSF, and to the EFC where the financial assistance is to be granted under the EFSM.’ See also: Arts 4(4), 13(1) TESM.

3028 Art 7(1) Reg 472/2013. See also: Art 13(3) TESM.

3029 Art 7(2)-(3) Reg 472/2013: (2) The Commission shall ensure that the [MoU] signed by the Commission on behalf of the ESM or the EFSF is fully consistent with the macroeconomic adjustment programme approved by the Council. (3) The Commission shall ensure consistency in the process of economic and budgetary surveillance with respect to a Member State under a macroeconomic adjustment programme to avoid duplication of reporting obligations.

3030 Art 7(4) Reg 472/2013. See also: Art 13(3) TESM.

3031 Art 7(2) Reg 472/2013. See also: Article 13(3) TESM, which adds that such conditionality ‘shall be fully consistent with the measures of economic policy coordination provided for in the TFEU ... including any opinion, warning, recommendation or decision addressed to the ESM Member concerned.’

3032 Art 7 Reg 472/2013. At the same time, the ESM BoG approves the MoU, which is signed by the Commission: Art 13(3)-(5) TESM.

3033 The macroeconomic adjustment programme supersedes all other surveillance and reporting requirements under the SGP and the EIP legislation: Arts 10-13 Reg 472/2013. Member States in receipt of financial assistance are automatically subject to enhanced surveillance, except those in the receipt of the PCCL, ECCL, or SMSF (which have no additional surveillance requirements). Where the Commission concludes that a Member State has deviated from its adjustment programme, it will recommend the adoption of corrective measures; the Council will reach a decision of non-compliance, and the Member State ‘shall take measures aimed at stabilising markets and preserving the good functioning of its financial sector’: Arts 2(3), 2(5), 3(3)-3(5), 7(7), Reg 472/2013.

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As shown in Section 6.3.4, in *Pringle v Ireland* the ECJ defended the legality of this arrangement by ruling that the duties confirmed on EU institutions ‘do not entail any power to make decisions of their own’ and ‘solely commit the ESM.’[^a] On this basis, the ECJ has repeatedly and consistently declined preliminary references or direct actions against macroeconomic adjustment programmes on the basis that the impugned acts are not acts of an institution, body, office or agency of the Union intended to create legal effects.[^b] On this basis, CJEU has rejected dozens of challenges concerning, *inter alia*:

- MoUs negotiated and signed by the Commission/ECB on behalf of the EU’s EFSM,[^c]
- Council Decisions and Council Implementing Decisions;[^d]
- Statements of the Eurogroup,[^e]
- MoUs negotiated and signed by the Commission for the ESM,[^f]
- Statements of the ECB;[^g] and
- MoUs negotiated and signed by the Commission for BoP assistance.[^h]

The (increasingly tenuous) assessment of the CJEU is therefore that the content of these legal instruments has nothing to do with EU law. As will be shown, this has become a vexing and expensive problem for private litigants. As a demonstration of the boundaries this thesis however, it is copacetic. As will be shown, these instruments are enacted acts of EU law under Article 288 TFEU, they constitute acts of EU institutions capable of grounding actions for damages,[^i] they classify as legal EU acts according to existing ECJ case law,[^j] and they are acknowledged as ‘binding legal commitments’ with the Commission [and] ECB’ by both EU and Member State

[^a]: *Pringle v Ireland* [160]-[164]).
[^b]: The jurisdiction of the court is confined to provisions of EU law: See, e.g., Case C-185/08 *Latchways and Eurosafe v Kedge Safety Systems BV* [2010] ECR I-10025; Case C-361/07 *Polier v Najar* [2008] ECR I-6 [9].
[^c]: Case C-128/12 *Sindicato dos Bancários do Norte and Others* order of 7 March 2013 [12]; *Profissionais de Seguros (Order of 7 March 2013)* [19]; *Profissionais de Seguros (Order of 21 October 2014)* [14]. In each case, the CJEU declined the reference on the basis that it ‘did not contain any specific evidence to support the view that that law was intended to implement EU law.’
[^d]: *Sindicato dos Bancários do Norte* [12]; *Profissionais de Seguros (Order of 7 March 2013)* [19]; *Profissionais de Seguros (Order of 21 October 2014)* [14]. Note that while in the first Portuguese case (C-128/12), the Council Decision was enacted after the offending measures at national level, in the latter two cases (C-264/12 and C-665-13), the Council Decisions were enacted first in time.
[^e]: C-105-109/15 *P Mallis; Mallis v Commission and ECB (Opinion of AG Wathelet)*; Case T-327/13 *Mallis v Commission*.
[^f]: Case C-8-19/15P *Ledra; Ledra (Opinion of AG Wahl)*.
[^g]: *Von Storch I* [34]; *Von Storch II* [36]-[38].
[^h]: *Case C-434/11 Corupul National al Politistilor* order of 14 December 2011 [16]; Case C-462/11 *Cozman v Teatrul Municipal Târgoviste* order of 14 December 2011, [13]-[15]; Case C-134/12 *Şi Ministerul Administraţiei Internelor (MAI) and others v Corupul National al Politistilor* order of 10 May 2012 [12]-%[14]; Case C-369/12 *Corupul National al Politistilor* order of 15 November 2012 [15].
[^i]: Case C-8-19/15P *Ledra*.
[^j]: Case C-409/13 *Council v Commission* [70]-[74]; Case C-613/14 *Irish Asphalt*.
It seems that the ECJ cannot acknowledge that these instruments are EU acts capable of legal effects without implicitly recognizing that they are also *ultra vires*. So it does not. This renders them ineffective as instruments of EU federalism: The Portuguese *Tribunal Constitucional*, in particular, has taken this as a cue to strike down numerous measures enacted in (theoretically) binding EU Council Decisions.  

There is perhaps no clearer demonstration that the new cornerstone of European fiscal federalism is outside the boundaries of the European legal order than that it is repeatedly disowned by the ECJ and subsequently struck down by Member State constitutional courts.

### 8.5.1 Acts of EU Law

As this thesis is concerned with the boundaries of the European legal order, this section is mainly concerned with those acts capable of grounding judicial review on the grounds of competence under Articles 263 TFEU (including those arriving by way of preliminary reference). That is so because Article 263 and 267 TFEU encompass legislative acts, implementing acts, delegated acts, including EU regulations, directives, decisions, and any other sui generis acts which are intended to produce legal effects, whatever their form.

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3044 In *Dowling v Minister of Finance* [2013] IEHC 27 [41.2](4) and *Case C-41/15 Dowling* [2015] OJ C 138/31 (reference of 2 February 2015) the Irish High Court pre-empted the usual response that these are not EU law by premising its reference on a finding of fact: That in entering the EFSM stability programme in November 2010, ‘the Irish State *entered into binding legal commitments with the European Commission, the European Central Bank*’ and was ‘legally committed to ensure recapitalisation in line with’ ECB and Commission assessments. AG Wahl has accordingly recognised that the Irish state entered *into binding legal commitments* with the Commission and ECB, including a commitment to recapitalise viable Irish banks.’ See: *Case C-41/15 Dowling v Minister for Finance* (Opinion of AG Wahl) [25]. See Section 8.5.3.

3045 LOE2014 (Portugal); LOE2013 (Portugal); LOE2012 (Portugal).


3047 An act will produce binding legal effects when it adversely affects the interests of a third party by bringing a distinct change to the substance of that party’s legal position: *IBM* [9]; Case C-521/06 *P Athinaiki Techniki v Commission* [2008] ECR I-5829 [42]-[44]; Case 322-09 *P NDSHT v Commission* (unreported, 18 November 2010) [45]-[48] (Commission letter finding no grounds for a state aid complaint amounts to a decision challengeable under Art 263 TFEU).

3048 *Case 22/70 Commission v Council (ERTA)* [1971] ECR 26 [41]-[42] [53] (proceedings of the Council constitute an act with legal effects where they concerned an agreement to coordinate negotiations on road transport); Case C-303/90 *France v Commission* [1991] ECR I-5315 (code of conduct concerning structural assistance has legal effects where it establishes obligations regarding content, frequency and means of reporting); Case C-325/91 *France v Commission* [1993] ECR I-3283 (interpretative communication from Commission has legal effects where introduces new obligations); Case C-39/93 *Syndicat Francais de l’Express International (SFEI) v Commission* [1994] ECR I-2681 (Commission letter closing the file on a complaint is capable of legal effects); Case T-3/93 *Air France v Commission* [1994] ECR II-121 (verbal communication from Commissioner that a merger falls outside EU competition law produces legal effects); Case C-57/95 *France v Commission (Re Pension Funds Communication)* [1997] ECR I-1627 [23] (Communication found intended to have legal effects, such that an action for annulment would lie against it.); Joined Cases 8-11/66 *Société anonyme Cimenteries CBR v Commission* [1967] ECR 75 [91] (opinion that a Treaty provision applies is equivalent to a
However, preliminary references and actions for annulment against EFSM and ESM Council decisions or MoU’s have been repeatedly and consistently rejected on the basis that they are not acts of EU institutions intended to create legal effects, or, if they are, that the national implementing act is not implementing EU law. In 2011-2012, for example, the CJEU dismissed a series of Romanian preliminary references concerning challenges to restructuring measures taken under an MoU signed by the Commission pursuant to BoP Assistance under Articles 143 TFEU and Regulation (EU) 332/2002. The court held that the national restructuring measures were not ‘intended to implement EU law.’

In 2012, the CJEU dismissed a string of Portuguese preliminary references concerning Charter challenges to restructuring measures taken under an EFSM MoU (note: the EFSM is an EU institution under Article 122(2) TFEU) signed between the Commission on behalf of the European Union and Portugal. In each case, the CJEU declined the reference on the basis that it ‘did not contain any specific evidence to support the view that that law was intended to implement EU law.’ This was so even though the measures were soon to be, or had already, been enacted in a Council Decision, and the Portuguese court twice reasserted the necessity of the reference because it considered those instruments to be binding EU acts.

In 2014, the CJEU dismissed ten claims brought against ESM conditionality by two groups of depositors in Cypriot banks, concluding that, in both cases, any legal effects of the bailout agreement were attributable to the Cypriot implementing law of the ESM MoU - which are ‘not part of the EU legal order’ and not challengeable under EU law. This was so despite CJEU recognition that: ‘the Commission, in cooperation with the ECB and the IMF, was responsible for negotiating the [MoU] with the Republic of Cyprus’; despite the fact that ‘it is true that the [statement of the Eurogroup] decision where it deprives party of an exemption of fines); Case 133/79 Sucrimex SA = v Commission [1980] ECR 1299 [12]-[19] (internal telex communication discussing decision is not a legal act); Case 182/80 Gauff Ingenieure GmbH v Commission [1982] ECR 799 (letter refusing to decide the eligibility of an undertaking in procurement not the outcome of a legal process and not a legal act); Case C-07/97 Oleificio Borelli SpA v Commission [1992] ECR I-06313 [9]-[13].


Case C-434/11 Corpul National al Politistilor [16]; Case C-462/11Cozman, [13]-[15]; Case C-134/12MAI [12]-[14]; C-369/12 Corpul National al Politistilor [15].

Case C-128/12 Sindicato dos Bancários do Norte [12]; Case C-264/12 Profissionais de Seguros [19]; Case C-665/13 Profissionais de Seguros [14].

Council Implementing Decision 2011/344/EU. Note that while in the first Portuguese case (C-128/12), the Council Decision was enacted after the offending measures at national level, in the latter two cases (C-264/12 and C-665-13), the Council Decisions were enacted first in time.

See, e.g., Case C-264/12 Profissionais de Seguros [15] (Court reiterating its reference even after the CJEU rejected the first preliminary reference); Case C-665/13 Profissionais de Seguros, [10] (‘considering that a decision of the Court on the interpretation of the … Charter is necessary to enable it to rule on the dispute before it’).

Mallis v Commission and ECB (Opinion of AG Wathelet) [68]; T-327/13 Mallis v Commission [54]-[59]; C-105-109/15 P Mallis [57]. See also: Case T-289/13 Ledra; Case C-8-9/15 P Ledra.

T-327/13 Mallis v Commission [61]. Approved in C-105-109/15 P Mallis [57].

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includes formulations that might seem categorical’;\textsuperscript{3056} and despite the fact that the MoU was enacted into binding secondary EU legislation.\textsuperscript{3057}

This has led to some absurd results. The \textit{Ledra} and \textit{Mallis} groups of cases are elucidative.\textsuperscript{3058} In those cases, the CJEU dismissed ten claims brought by depositors in Cypriot banks against bank-restructuring terms contained in an ESM MoU and Eurogroup Statement. The claimants argued that the depositor bail-in conditions which caused the loss of their deposits were assessed, negotiated, drafted and agreed by the Commission and ECB and were, in reality, \textit{ultra vires} acts of those institutions.\textsuperscript{3059} The appellants argued, \textit{inter alia}, that the ECB issued an autonomous ‘unless-demand’ which only it had the power to make: that if Cyprus did not agree to the terms, ‘the ECB would cut off bank liquidity to Cyprus forthwith.’\textsuperscript{3060} That being so, it was argued that, ‘The said coercive power is vested exclusively in the ECB ... the ECB must have been acting as an EU institution.’\textsuperscript{3061}

Yet in both groups of cases, the ECJ relied on \textit{Pringle} to hold that the impugned acts were not acts of EU institutions, arguing that ‘the duties conferred on the Commission and the ECB within the TESM do not entail any power to make decisions on their own and ... solely commit the ESM.’\textsuperscript{3062} This seems convincing, until one remembers that the ESM MoUs negotiated and signed by the Commission on behalf of the ESM are simultaneously enacted into Council Decisions in accordance with Article 7 of Reg 472/2013 and implemented under binding EU law.\textsuperscript{3063}

One must take a moment to imagine this procedure from the view of the aggrieved litigant: When a Member State requests financial assistance, the Commission and ECB assess, negotiate, agree and monitor the macroeconomic adjustment programme and the terms of the financial assistance simultaneously on behalf of the Union under EU law (Article 7 Reg 473/2013), and on behalf of the ESM under the ESM Treaty (Article 13(1)-(7) TESM). The conditions are then simultaneously

\begin{footnotesize}
\textsuperscript{3056} T-327/13 \textit{Mallis v Commission} [61]. Approved in \textit{Joined Cases C-105-109/15 P Mallis} [57].
\textsuperscript{3057} Council Implementing Decision 2013/463/EU of 13 September 2013 on approving the macroeconomic adjustment programme for Cyprus and repealing Decision 2013/236/EU [2013] OJ L 250/50
\textsuperscript{3058} T-327/13 \textit{Mallis v Commission} and C-105-109/15 P Mallis; Case T-289/13 \textit{Ledra} and Cases C-8-9/15 P \textit{Ledra}.
\textsuperscript{3059} The terms required Cyprus to integrate Cyprus Popular Bank into Bank of Cyprus. Joined Cases C-8-9/15 P \textit{Ledra}, attacked the MoU agreed between the ESM and Cyprus in an action for damages, arguing that the writing-in of depositor bail-ins caused the loss of their deposits was, in fact an act of the Commission and ECB. Joined Cases C-105-109/15 P \textit{Mallis}, sought to annul the 25 March 2013 Eurogroup Statement setting out the terms of conditionality, arguing that the offending terms were assessed, negotiated, drafted and agreed by the Commission and ECB.
\textsuperscript{3061} \textit{Ledra}, para 1(c) (emphasis in original).
\textsuperscript{3062} T-327/13 \textit{Mallis v Commission} [45], approved in \textit{Joined Cases C-105-109/15 P Mallis} [55]-[57]. See also: \textit{Joined Cases C-8-9/15 P Ledra} [50].
\textsuperscript{3063} Council Decision 2014/236/EU; Council Implementing Decision 2013/236/EU.
\end{footnotesize}
passed to a meeting of the ‘Eurogroup’ (in which the ECB and Commission participate), and a meeting of the ESM BoG (chaired by the President of the Eurogroup and in which the Commission and ECB participate). Once approved, ESM conditionality is simultaneously signed by the Commission (on behalf of the ESM), and enacted into a binding Council Decision by the Union in its Eurogroup configuration. It is important to note, as AG Wathelet has pointed out, the Eurogroup, the ESM BoG, and the EMU Council are ‘composed of exactly the same members.’ Indeed, this entire procedure can be accomplished without anyone leaving or entering the room.

So who is responsible for the terms of the macroeconomic adjustment programme? Under Article 7 of Reg 472/2013, the Commission is under a legal duty to ensure that ‘the [MoU] signed by the Commission on behalf of the ESM or the EFSF is fully consistent with the macroeconomic adjustment programme approved by the Council.’ But the Commission is not responsible for its contents, because that would be ultra vires, per Pringle. Similarly, the Eurogroup is not an institution capable of creating binding legal acts for the purposes of EU law, and is therefore not legally responsible for its contents either, per Mallis. The Council Decision is also not challengeable, however, because its application is interposed with national implementing law. The only entity accountable for the depositor bail-in is the ESM. But this, alas, is not an institution of the Union and cannot be challenged before the ECJ.

Thus, the same 21 people (the EMU finance ministers plus the Commission and ECB), sitting in three identical configurations, - swapping back and forth between three different ‘caps’ - are completely immune from judicial review at EU level because the only configuration which is not acting ultra vires is that of the ESM – which, per Pringle, is only lawful if it replicates EU financial conditionality to the letter anyways. For the aggrieved lay applicant, this entire affair must seem more apt to a Monty Python sketch than the cornerstone of a new model of European fiscal federalism.

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3064 ECB and Commission participation is set out under Art 1, Protocol of the Eurogroup.
3065 Art 5(3) TESM
3066 Art 5(3) TESM; Art 13(4) TESM.
3067 Art 7(2), 7(3) Reg 372/2013.
3068 The President of the Eurogroup is the Chairman of the ESM (Art 5(2) TESM), and both the Eurogroup and ESM BoG consist of the same configuration of the EMU finance ministers, accompanied by the Commission and ECB (Art 5(2) TESM.). This configuration is also the exact same configuration of members as a configuration of the Council when voting on recommendations and sanctions under the EU governance procedures. Mallis (Opinion of AG Wathelet) [71].
3069 Art 7(2) Reg 472/2013. Pringle v Ireland [164]; Ledra (Opinion of AG Wahl) [58]-[59] (‘so that it should refrain from signing a memorandum of understanding whose consistency with EU law it doubts’).
3070 See: Section 6.3.4. Pringle v Ireland [160]-[164].
3071 Joined Cases C-105-109/15 P Mallis [55]-[57] (while ‘it is true that the annex to the contested declaration includes formulations that might seem categorical,’ the Eurogroup was not capable of creating legal acts).
3073 See: Section 6.3.3, in particular at 6.3.3.2, pp 223-223. Pringle v Ireland [111]; Pringle v Ireland (AG Kokott) [92].
Finally, if the idea that the MoU is an act of the ESM over which EU institutions have no power of compulsion still seems convincing, one might recall here that the Romanian, Irish, Portuguese cases concerned MoUs signed by the Commission on behalf of the Union, using EU finances, and implemented through Council decisions under Reg 407/2010 – binding EU law.3074 Yet these, too, were rejected.

8.5.2 Acts of EU Institutions

In those cases where secondary EU law itself has been challenged, the ECJ has avoided the ultra vires issue by holding that it is not the binding EU law that is faithfully being implemented by the Member State, but another ultra-EU norm. This is so even where the norm is the implementation of a binding EU law instrument that would appear to be clear, precise, and leaves no discretion to the addressee.3075

ADEDY v Council is instructive.3076 In that case, the litigants challenged, on ultra vires and human rights grounds, Council Decisions giving notice to Greece pursuant to its bailout programme under the EDP. Those decisions contained a list of highly-specific imperatives, including the following:

‘Greece shall adopt the following measures by the end of September 2010: […] (b) a unified statutory retirement age of 65 years…’ 3077

Since it is difficult to imagine an imperative as clear and automatic as a binding Council decision to ‘set the retirement year at 65 by 30 September 2010,’ the applicants contested:

‘the measures which may be decided upon by the council under the [EDP] and included in its decisions cannot be prescribed specifically, explicitly and without room for deviation, since that competence is not conferred upon the Council by the Treaties.’3078

Yet the court concluded that these provisions were not acts of EU institutions capable of direct concern. In Case T-541/10 ADEDY the court held (perhaps preposterously) that the requirement to

3074 Case C-434/11 Cor pulitistilor [16]; Case C-462/11Cozman, [13]-[15]; Case C-134/12MAI [12]-[14]; C-369/12 Cor pulitistilor [15]. Case C-128/12 Sindicato dos Bancários do Norte [12]; Case C-264/12 Professioais de Seguros [19]; Case C-665/13 Professioais de Seguros [14]; Case C-64/16 Juizes Portugueses (Preleminary reference); Case C-41/15 Dowling v Minister for Finance.
3075 In order to be of direct concern, the contested measure must directly affect the legal situation of the individual and leave no discretion to its addressees, which are entrusted with the task of implementing it. Such implementation must be ‘purely automatic and resulting from EU rules without the application of other intermediate rules.’ Joined Cases 41-44/70 International Fruit Co v Commission [1971] ECR 411.; Case 11/82 Piraiki Patraiki v Commission [1985] ECR 207 (direct concern may arise where the likelihood of the addressee of the measure not complying with the measure is purely theoretical and the addressee’s intention to act is not in doubt); Joined Cases 106-107/63 Toepfer v Commission [1965] ECR 405 and Case 62/70 Werner A Bock v Commission [1971] ECR 0897 (direct concern found where Member State asked for Commission for confirmation of decision to issue licence and commission decision binding); Case 123/77 UNICME v Council [1978] ECR 845.
3076 Case T-541/10 ADEDY v Council (Order of 27 November 2012); Case T-215/11 ADEDY v Council.
set the retirement age at 65 ‘left a very wide discretion to the Greek authorities to define the content of the law which was to implement it.’\textsuperscript{3079}

Thus, as long as any national measure is interspersed between the EU economic policy and the applicant, the courts have dismissed the possibility that non-compliance with these measures ‘is purely theoretical and [the] intention to act in conformity is not in doubt.’\textsuperscript{3080}

These cases are remarkable, however, in that they do not avoid the conclusion - so far denied in those cases arriving by preliminary reference - that the EU decision is a legal act of economic policy. In fact, these decisions appear to confirm as much. In Case T-541/10 \textit{ADEDY}, for example, the court openly accepted that the decision ‘sets a clear objective which must be achieved by the reduction of the bonuses paid to civil servants, that is to say the saving of a certain sum per year.’\textsuperscript{3081} In Case T-215/11 \textit{ADEDY}, the court stated that, \textit{inter alia}, ‘the first disputed provision imposes on the Hellenic Republic a fiscal objective, i.e., at least EUR 7 billion during the period 2011-2013 at least 1 billion euros in 2011.’\textsuperscript{3082} The courts appear to confirm the main point of this chapter - that the EU does legislate economic policy – it just cannot acknowledge its hand at the controls if it is caught doing so.

\subsection*{8.5.3 Assessment: An Untenable Choice between the \textit{Ultra Vires} and the Inapplicable}

There are two problems with this case law. First and most obviously, the ECJ still has not answered the problem that EFSM and ESM macroeconomic programmes are duplicated in EU Council decisions, and these decisions are binding in their entirety under Article 288 TFEU. In \textit{Ledra}, for example, AG Wathelet defended this position on the basis that:

‘national measures adopted on the sole basis of the MoU do not constitute an implementation of EU law by the Member States, even though the second subparagraph of Article 13(3) of the TESM provides that ‘the MoU shall be fully consistent … with any act of … Union law.’\textsuperscript{3083}

But this makes little sense. The Council Decision is legally binding - the MoU is not. It seems odd to conclude that the Member States are complying solely with the terms set out in MoU and not the identical terms set out in the binding Council Decision. The additional financial incentives of the MoU do not change the fact that the Member State is bound by EU legislation to take specific action in a field in which the EU has no legislative competence. This problem was admitted by AG Wathelet himself, who noted:

\textsuperscript{3079} Case T-541/10 \textit{ADEDY} [71]-[76]. See also: Case T-215/11 \textit{ADEDY} [64].
\textsuperscript{3080} Case T-541/10 \textit{ADEDY} [71]. See also Case T-215/11 \textit{ADEDY} [62]-[64].
\textsuperscript{3081} Case T-541/10 \textit{ADEDY} [70].
\textsuperscript{3082} Case T-215/11 \textit{ADEDY} [84].
\textsuperscript{3083} Mallis v Commission and ECB (Opinion of AG Wathelet) [84]. The ECJ sidestepped this problem entirely, but agreed that the Member State was not obeying EU law when it obeyed the MoU. C-105-109/15 \textit{P Mallis} [60].
Up to now, however, any measures contained in an MoU adopted under the ESM have also been contained, in varying degrees of detail, in a Council Decision adopted under the FEU Treaty by the Council, a procedure perhaps dictated by the fear that the MoU is not legally binding. The Council decisions thus addressed to a Member State support the view that national measures adopted pursuant to commitments entered into by a Member State vis-à-vis the ESM constitute an implementation of EU law.\textsuperscript{3084} (Emphasis added)

Whatever else is happening between the government and the ESM, it remains that the Member State is bound by EU law. No answer has been forthcoming on how to reconcile this with the EU legal order, except to say that the Member States probably don’t have the EU law in mind when they faithfully execute it to the letter.

Second, these cases ignore the reality that the Commission and Council do take decisions which can, as shown in Section 6.3.2, only be attributed to their own acts according to existing case law. The Commission and ECB have a power – under binding secondary EU law – to take specific decisions when drafting macroeconomic programmes, and these decisions are: acts of EU institutions capable of grounding an action for non-contractual liability;\textsuperscript{3085} acts which are duplicated in EU Council Decisions under Reg 472/2013 and binding under Article 288 TFEU;\textsuperscript{3086} acts which constitute ‘binding legal commitments with the Commission [and] ECB’;\textsuperscript{3087} and they are acts which classify as reviewable legal acts of EU institutions according to C-409/13 Commission v Council.\textsuperscript{3088} However, if the CJEU acknowledges these acts as acts of EU institutions, then it will be difficult not to acknowledge that they are also ultra vires.

Ledra is instructive. In that case, the ECJ held that the Commission’s duty to ensure that the MOU is ‘fully consistent with EU law’ was capable of constituting an act attributable to that EU institution capable of grounding an action for non-contractual liability against the Commission.\textsuperscript{3089} Yet, on the other hand, the challenges on ultra vires grounds in Pringle, Ledra and Mallis, are all dismissed because the legality of the ESM framework depends on the conclusion that Commission and ECB do not have ‘any power to make decisions on their own and … solely commit the ESM.’\textsuperscript{3090} But these are disjunctive propositions. The Union cannot have it both ways.

Perhaps unsurprisingly, national courts viewing themselves to be applying binding EU law have taken an increasingly dim view of this dis-ownership of EU macroeconomic adjustment...
programmes.3091 In May 2016, for example, the Portuguese Tribunal Constitucional referred a challenge by Portugal’s Judges that explicitly asks the ECJ to complete the link between EU law and national implementing measures, ‘In view of the mandatory requirements of eliminating the excessive budget deficit and of financial assistance regulated by EU rules.’3092 Similarly, in Dowling v Minister for Finance, the Irish Government has attempted to defended itself against violations of EU company law by arguing that bank restructuring orders were required under binding EU law (i.e. Council decisions under Ireland’s EFSM programme).3093 In its preliminary reference, the Irish High Court has preempted the usual response that these are not EU law by premising its reference on a finding of fact: That in entering the EFSM stability programme in November 2010, ‘the Irish State entered into binding legal commitments with the European Commission, the European Central Bank’ and was ‘legally committed to ensure recapitalisation in line with’ ECB and Commission assessments.3094 This has, so far, forced AG Wahl to accept that, ‘the Irish state entered into binding legal commitments with the Commission, the ECB and the IMF.’3095

Such cases have evidently tied the European Courts into an untenable position. How can it be that the terms of these macroeconomic adjustment programmes are not EU law, but under Articles 6 and 7 of Reg 472/2013, the Member States are legally prohibited – by an act of EU law - from doing anything else? The Opinion of AG Wahl in Dowling evinces this quandary perfectly. On one hand, it is accepted that:

‘To be sure, pursuant to Article 3(5)(a) of the Implementing Decision, there was a common understanding… Ireland was giving effect to the condition for financial assistance to recapitalise its banks, as laid down in Article 3(5)(a) and (7)(g) of the Implementing Decision…’3096

On the other hand, since this would render the measure ultra vires:

‘That said, I must admit to being more hesitant with regard to the argument that EU law obliged Ireland to recapitalise as it did… In that connection, as the Commission rightly pointed out at the hearing, the Implementing Decision is ultimately rooted in Article 122(2) TFEU, a provision which refers to providing ‘financial assistance’ under ‘conditions’, rather

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3091 A direct action for damages from Cyprus under Article 380(2) has challenged the Commission and ECB’s role in negotiating and drafting provisions of an ESM MoU as outside EU law, alleging a violation of non-discrimination and Charter rights: Case C-161/15 Brinkman. A aggressive reference from the Alba Iulia Court of Appeal (Romania) cites prior jurisprudence (France Pension Funds Communication [17]-[23] in which the CJEU annulled a Commission Communication on grounds of competence, and again raises the issue of whether an EU MoU between the EU and Romania is an act of EU law: Florescu [4]. It asks: ‘was it lawful for the European Commission to require, for the purposes of reducing the effects of the economic crisis, the adoption of a national law which barred retired officials of the public institutions from receiving a salary in addition to the pension?’

3092 Case C-64/16 Juízes Portugueses [2016] OJ C 156/32.


3095 Case C-4115 Dowling v Minister for Finance (Opinion of AG Wahl) [25].

3096 Dowling v Minister for Finance (Opinion of AG Wahl) [55]-[57] [91].
than conferring upon the European Union the power to set binding economic policy objectives.’ Hence, it is not obvious that the European Union had unilaterally imposed an obligation. 3097

To the frustrated bank depositor, this must make little sense. Which is it? A legally-binding Council Decision from which Member States cannot depart under Articles 6-8 of Reg 472/2013, or not an act of EU law at all, in which case, their constitutional legal rights may be vindicated against it before national courts? These instruments thus typify the essential thrust of this chapter: The new model of European fiscal federalism is comprehensively dependent, for its functioning, on instruments which are manifestly beyond the boundaries of the EU legal order and may perhaps exist only in so far as they are not actually enforced.

8.6 Conclusion: Six Fundamental Incompatibilities with the European Legal Order

The conclusion of this chapter is that the fiscal governance architecture upon which the European proto-fiscal union depends is manifestly incompatible with the European legal order. Fully seven out of the eight legal mechanisms examined in this chapter violate an explicit ruling or constitutional test set for what is a permissible constitutional state in the realm of fiscal sovereignty.

At EU level, the new model depends, for its effective operation, on continuous Member State acquiescence to intensified governance regimes which bear no relation to the legislative competences of the Union; 3098 which extend the unilateral discretion of the Commission, 3099 and which fail to adhere to the ‘community method’ or ‘intergovernmental method’ at EU level - complete with a voting formula that allows the Commission to autonomously issue and sanction policies against a population majority of up to 93.61% or numerical majority of fifteen countries, with zero votes of support. 3100

At Member State level, it is dependent on the constitutionality of a complex and beguiling ‘quasi-legislative’ legal framework that stretches athwart the gap between legal orders to inject binding EU economic policies directly into EU law. The term ‘quasi-legislative’ is used here because, while economic policy recommendations are not formally binding (non-implementation will not lead to infringement for breach of the recommendation), EU legislation has implanted vehicles in Member State legal orders to meet these prescriptions at the border and shuttle them into Member State democratic processes. The result of these interlinkages is a sort of conjunctive direct effect: Substantive, sanction-backed EU economic policies are not directly applicable at national level, but the result is the same: The EU writes the policy prescription, and national courts must enforce it under binding secondary EU law.

3097 Dowling v Minister for Finance (Opinion of AG Wahl) [55]-[57].
3098 See: Section 8.4.1.
3099 See: Sections 8.4.2 and 8.5.
3100 See: Section 8.3.4.
This is a feature of unitary states that the European constitutional order simply cannot support. The piece-by-piece deconstruction carried out in this chapter has identified seven mechanisms which trespass on the boundaries of fiscal sovereignty set out under the ‘constitutional identity’ jurisdictions identified in Chapter 1 in this thesis. These architectures are as follows:

[8.2] First, a complex constellation of provisions under Articles 3, 4(1), 4(4), 5(1)-(2), 6(1) and 7(1) of Regulation 473/2013, and Articles 4-6 and 10(4) of Directive 2011/85/EU, have made substantial amendments to national fiscal frameworks, such that failure to internalise EU macrofiscal assessments and numerical targets will lead to a breach of EU legislation both directly and as result of national budgetary laws implanted there by EU legislation. [8.2.1] First, a budgetary framework which allows the government to depart from the macrofiscal assessments of the Commission or the EU-governed fiscal body will be in breach of EU law for failing to adhere to the required scenario produced by the Commission or EU-legislated fiscal body; for failing to adopt a budget endorsed by the EU-legislated fiscal body; and for failing to internalise EU numerical targets under national fiscal laws implanted there by EU legislation. [8.2.2] Second, under Article 7(1) of Reg 473/2013, the Commission may declare the draft budget in ‘particularly serious non-compliance’ with the obligations in Articles 3, 4(1) and 6(1), even if this only concerns specific substantive economic policy choices, and even where there are no spillovers to the union. It will remain in breach of those obligations until the Commission approves the budget. These machineries grip each link in the ‘chain of legitimation’ that is ultra vires their legal basis and in danger of repudiation from national constitutional courts.

[8.3] Second, it is the MTO produced by the Commission and the Council under Article 5(1) Reg 1466/97 – not the assessment of the Member State - which defines the appropriate MTO adjustment path for the purposes of Directive 2011/85/EU; budgetary processes, fiscal plans (SCPs) and draft budgets under Reg 473/2013; and for enforcement against all subsequently-enacted budgetary legislation under Articles 3(1)(b) TSCG and 5(2)(a) of Reg 473/2013. [8.3.2] Article 5(2)(a) of Reg 473/2013 then stretches athwart the gap between legal orders and inserts the Commission warning in Article 6(2) of Reg 1466/97 into the TSCG. This co-opts the TSCG and requires Member States to hand their constitutional correction mechanism to the Commission. [8.3.3] Directive 2011/85/EU then places Member States under a legal duty, to place themselves under a legal duty, to comply with the EU’s fiscal rules - which themselves are not legal duties. These binding interlinkages with the EU fiscal governance regime constitute a manifest breach of constitutional identity and the ‘essential conditions for the exercise of national sovereignty’ according to the

\[3101\] Articles 4(1) and 10 of Directive 2011/85/EU.
\[3102\] Articles 4(4), 5 of Reg 473/2013, in conjunction with Directive 4(1) and 10 of Directive 2011/85/EU.
\[3103\] Articles 5 of Reg 473/2013 and 5 of Directive 2011/85/EU/ See Section 8.2.1.
\[3104\] Arts 4-5, 9-14 Directive 2011/85/EU.
\[3106\] Section 8.3.2.
explicit rulings of, inter alia, the BVerfGE in Re ESM II (Germany), the Conseil Constitutionnel in TSCG (France), and the VfGH in in TSCG (Austria).

[8.4] The expansive scope of the IDR and AMR, combined with Articles 3 and 10(4) of Reg 1176/2011 extends the legal machinery in Section 8.2.2 of this Chapter to essentially any economic situation in any Member State – even if there are no spillovers to the Union and no overlap with any of the Union’s competence. This arrangement is manifestly incompatible with the test for unlawful dispositions or expropriations of fiscal sovereignty under the ‘constitutional identity’ jurisdiction set out in Section 1.3.1.5 of this thesis.

[8.5] Conditional financial instruments typify the essential thrust of this chapter: The new model of European fiscal federalism is comprehensively dependent, for its functioning, on instruments which are manifestly beyond the boundaries of the EU legal order and may perhaps exist only in so far as they are not employed. MoUs negotiated and signed by the Commission/ECB for EU financial assistance under 122(2) or 143 TFEU,3107 Council decisions,3108 statements of the Eurogroup,3109 MoUs negotiated and signed by the Commission/ECB for the ESM;3110 and statements of the ECB,3111 cannot be enforced as directly applicable and supreme EU law instruments because they legislate policy outcomes that are manifestly beyond the boundaries of the EU legal order and vulnerable to repudiation by national constitutional courts. Accordingly, the (increasingly tenuous) position of the CJEU is that these are not acts of EU law at all. This renders them ineffective as instruments of fiscal federalism.3112

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3107 Declining to review EFSM MoU’S: Case C-128/12 Sindicato dos Bancários do Norte [12]; Case C-264/12 Professionais de Seguros [19]; Case C-665/13 Professionais de Seguros [14]. Declining to review BoP MoU’s: Case C-434/11 Corpu National al Politistilor [16]; Case C-462/11Cozman, [13]-[15]; Case C-134/12MAI [12]-[14]; C-369/12 Corpu National al Politistilor [15].
3108 Case C-128/12 Sindicato dos Bancários do Norte [12]; Case C-264/12 Professionais de Seguros [19]; Case C-665/13 Professionais de Seguros [14]; In each case, the CJEU declined the reference on the basis that it ‘did not contain any specific evidence to support the view that that law was intended to implement EU law.’
3109 Joined Cases C-105-109/15 P Mallis.
3110 Joined Cases C-8-10/15 Ledra.
3111 Von Storch I; Von Storch II.
3112 The Portuguese court, for example, has famously struck down innumerable measures enacted in (theoretically) binding EU Council Decisions under its bailout programmes. LOE2014 (Portugal); LOE2013 (Portugal); LOE2012 (Portugal); Spiegel and Wise, 'Portugal’s anti-austerity budget provokes Brussels showdown' (2016).
Conclusion
Conclusion: Constitutional Criteria for EU Fiscal Federalism

In order to remain stable and permanent as a matter of law and economics, European fiscal federalism must do two things: It must, first, be compatible with the constitutional boundaries of the European legal order; and, second, it must ‘work’ – i.e., it must not be economically unstable. The thesis of this study is as follows:

First, any model of European fiscal federalism must preserve the fiscal sovereignty of the twenty-eight constitutional democracies which form the basis of its legal order. This means, specifically, that any machineries of public economics which trespass on the tests for democratic legitimation under Member State ‘constitutional identity’ and ‘ultra vires’ review jurisdictions will not take effect in the legal system, and will not be compatible with the European legal order. In all twenty-seven Member State constitutions studied in this thesis, no state institution may validate an exercise of public power that is not democratically legitimated in the manner specified in the constitution. All, including the most basic among them, preclude a disposition of the Kompetenz-kompetenz. The most developed, such as the German ‘eternity’ clause, entrench a specific formula for democracy: they require, in essence, that fiscal powers can only be exercised by institutions according to formula, and these components themselves are unamendable. Fiscal sovereignty is a permanent constitutional constraint upon the application of fiscal federalism theory in the European Union.

Second, hard budget constraints and individual exposure to market discipline are indispensable requirements for compliance with the fundamental guiding principles of price stability, sound public finances and a sustainable balance of payments under Article 119 TFEU. Systems of fiscal federalism theory which substitute hard budget constraints for centralised legal governance are not compatible with the guiding principles of price stability and fiscal discipline, and are not compatible with the European legal order. In particular, the BVerfGE has held that the ‘no bailout rule’ and ‘no monetary financing rules’ safeguard the Bundestag’s ‘national budgetary responsibility,’ and Germany’s constitutional identity would be violated if the Stabilitätsgemeinschaft should become a ‘liability community’ through the ‘direct or indirect communitarisation of state debts.’

This study concludes that the European Union has embarked upon a model of ‘fiscal union’ that is fundamentally incompatible with the European legal order. Seven centuries of history and empirical data from 106 sub-federal government units in Germany, Canada, Switzerland and the US admonish that the flaw at the heart of the euro is not the budgetary freedom of national electorates, nor their

3113 See: Section 1.2.1.
3114 Re ESM I (Germany) [203]; Re ESM II (Germany) [167]-[171]; Aid Measures for Greece (Germany) [129], [137]. See also: Gauweiler I (Germany) [41] ‘[A] system of fiscal redistribution… is not entailed in the integration programme of the European Treaties… independence of the national budgets, which opposes the direct or indirect common liability of the Member States for government debts, is constituent for the design of the monetary union.’

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economic diversity, nor the small size of the EU budget. The fatal flaw at the heart of the euro is the pooling of debts and constricted democratic choice. Under this system, interest rates do not rise,\textsuperscript{3115} governments do not act,\textsuperscript{3116} and electorates do not feel the costs of their own debts.\textsuperscript{3117} When the credit-market adjusts, the terms of reform are selected by creditors – not the voters who must bear them. Systems of law which develop up to uphold such conditions must then inevitably conflict with Member State ‘constitutional identity’ jurisprudence. If Europe is not to continue further down this lonely, troubled path, the misguided belief in the \textit{sui generis} nature of European integration must not become an excuse to ignore every fundamental lesson of fiscal federalism and OCA theory.\textsuperscript{3118} There is no mystery as to where it leads. The fiscal federalism literature is remarkably united its prescriptions, and history is littered with federal systems pulled-apart by the creeping pathologies of SGFF theory spreading across the constitutional framework with each marginal contract for debt.

Though unlike federations presupposed upon a single ‘constitutional demos,’ the turmoil which lies at the end of this path for the European Union is not just economic, but constitutional.\textsuperscript{3119} By restricting fiscal autonomy and providing bailouts, the EU has taken a ‘departure from the traditional paradigm of the EU economic constitution.’\textsuperscript{3120} In order for a union founded on the conferred powers to support this shift, such a fundamental change of regime requires repudiation of, \textit{inter alia}, the ‘eternity clause’ of the German Constitution by enacting a new constitution upon a free decision of the German people under Article 146 BL (against which lies a right to resist the abolishment of the constitutional order under Article 20(4) BL).\textsuperscript{3121} This is not to mention the eighteen other constitutions catalogued in this thesis which have their own versions of these unamendable core provisions. As Adamski observes, '[T]he political constitution preventing supranational institutions from countering excessive macroeconomic imbalances in Member States renders any fiscal union a suicidal mission.'\textsuperscript{3122} Mallegheim offers a similar warning: ‘Paradoxically, the policy response to

\textsuperscript{3118} Blume and Voigt (2013), 238: ‘The literature on the fiscal effects of fiscal institutions is well established, as is the underlying theory.’ Wibbels (2003), 476: ‘Despite the fact that scholars of comparative federalism are conducting research in remarkably diverse national contexts, they are increasingly united in their prescription for the economic compulsions of some federations.’ See also: Landon and Smith (2000), 635.
\textsuperscript{3119} MacCormick, 'Beyond the Sovereign State' (1993); Weiler, 'Europe's constitutional Sonderweg' (2003) 9; Mayer (2009); De Bürca and Weiler (2012); Avbelj and Komárek (2012); Sankari and Tuori (2013).
\textsuperscript{3120} Edoardo Chiti and Gustavo Teixeira (2013), 700.
\textsuperscript{3121} Art 20(4) BL states: ‘All Germans have the right to resist any person seeking to abolish this constitutional order, should no other remedy be possible.’ \textit{Re Lisbon (Germany)} [155]: ‘Art 146 [BL] sets out, in addition to the substantive requirements laid down in art.23.1 … the ultimate boundary of the participation of [Germany] in European integration. it is the constituent authority alone, not the constitutional authority emanating from the constitution, which is entitled to release the state constituted by the Basic Law.’ See also: \textit{Aid Measures for Greece (Germany)} [101].
\textsuperscript{3122} Dariusz Adamski, 'Europe's (Misguided) Constitution of Economic Propserity' (2013) 50 CMLR 47, 56.
the crisis might be even more threatening to the survival of the eurozone and, indeed, the EU as a whole.” 3123 Wyplosz concludes:

‘Fiscal discipline is thoroughly needed, but centralization is not necessary. … The main objective must be to decentralize both the design of fiscal rules and their implementation, while restoring the no-bailout clause. Ignoring this clause has opened the way to further centralization, which is a major source of conflict and an approach that will ultimately fail.” 3124

Proposed solutions and directions for further study are offered at the end of this conclusion. For the purposes of this conclusion, the findings presented here are extracted from this thesis as follows:

Part I of this study identified two permanent constitutional boundaries of the European legal order that constrain European fiscal federalism de lege lata and de lege ferenda:

The first is fiscal sovereignty. This principle is impressed upon the allocation of competences in economic policy (Articles 2(3) and 5(1) TFEU) and the substantive provisions governing public finance (Articles 121-126 TFEU). Under those articles, economic policy remains completely outside the boundaries of the European legal order. Notwithstanding any amendment to the Treaties, this marks an immutable constitutional boundary of the European legal order. Under Articles 4(1), 5(1) and 5(2) TUE, the limits of Union competences are governed by the principle of conferral, and under Articles 48(4) TUE, 49 TUE, 54 TUE, and 357 TFEU the Union acquires its competences when they are ‘ratified by the High Contracting parties in accordance with their respective constitutional requirements.” 3125 In so far as this is so, it can have no powers other than what the Member States have given it, and nemo plus iuris transfere (ad alium) potest quam ipse habet, what the Member States have given it is limited by their own constitutional identities. 3126 Not only has economic policy not been conferred on the Union, it cannot ever be so conferred without abrogating, inter alia, the Democratic State (Article 20 BL) shielded by the ‘eternity clause’ (Article 79(3)) of the German Basic Law 3127 and numerous other Member State courts have drawn similar boundaries around their own constitutional formulas for fiscal sovereignty. 3128

3123 Van Malleghem (2014) 130.
3125 See also: Art 42(2) TUE (decision on a common defence); Art 50(1) TUE (unilateral withdrawal); Art 25 TFEU (amendment of the rights in Art 20(2) TFEU); Art 223(1) TFEU (amendment of parliamentary election period); Art 262 TFEU (conferral of jurisdiction in intellectual property rights); Art 311 TFEU (amendment of own resources).
3126 See, e.g., Germany: Re Lisbon (Germany) [221]. Denmark: Carlsten (Denmark) [13]; Poland: ESM & TSCG (Poland) [6.3.1] SPUC v Grogan I (Irish Supreme Court), 769 and 770.
3127 Re Lisbon (Germany) [228], [232]; Aid Measures for Greece (Germany) [107], [127]; Re ESM I (Germany) [193], [196]; Re ESM II (Germany) [161]-[165]; Gauweiler I (Germany) [28]; Gauweiler III (Germany).
3128 France: Re Maastricht I (France) [43]; Re Maastricht II (France) [31]-[35], [42]-[43]; TSCG (France) [16]; Ireland: Crotty (Ireland), 783; Pringle I (Ireland Supreme Court) [8.14]; Collins v Minister for Finance (Ireland) [95]-[98]. Poland: Lisbon (Poland), 200; ESM & TSCG (Poland); Estonia: ESM (Estonia) [105], [106], [144]. Czech Republic: Lisbon I (Czech Republic) [91], [93]. Spain: Catalonia v State Solicitor DTC 134/2011 (Spain) [8][a]. Austria: ESM
The second constitutional boundary is comprised of the fundamental guiding principles of price stability and fiscal discipline set forth in the mandate for EMU under Article 119 TFEU. According to the BVerfGE, the fundamental principles of the Stabilitätsgemeinschaft are ‘the basis and subject-matter of the German Act of Accession.’\footnote{Brunner (Germany) \[80]-[89]. See also: Aid Measures for Greece (Germany) \[129]; Re ESM I (Germany) \[203]; Gauweiler I (Germany) \[32].} This encompasses, specifically, the price stability mandate of the ECB (Article 127 TFEU), the prohibition on monetary financing (Article 123 TFEU), the ‘no-bailout’ clause (Article 125 TFEU), and the stability criteria of the ‘Stability and Growth Pact’ (Articles 121,126 TFEU).\footnote{Art 121, 126 TFEU. Price stability and the Stabilitätsgemeinschaft has been linked by the BVerfGE to the independence of the ECB, the prohibition on monetary financing, the no-bailout clause, and the stability criteria under the SGP: Brunner (Germany) \[89], \[204]-[205]; Aid Measures for Greece (Germany) \[181]-[182]. Re ESM I (Germany) \[203]-[204].} It should be noted that the price stability mandate of the ECB is, in principle, amendable under Article 88(1) of the German Basic Law, however the architecture of the Stabilitätsgemeinschaft also shields the principles of the Democratic State (Article 20 BL) and human dignity (Article 1 BL)\footnote{This is so as a result of the right to property under Art 14 of the German Basic Law, which guards against the expropriation of savings through inflation, and is incorporated into Art 1 (Human dignity) shielded from amendment by the German ‘constitutional identity’ clause (Art 79(3) BL).} which are part of the constitutional identity shielded by the ‘eternity clause’ (Article 79(3) BL) and are not amendable, \textit{lex lata or lex ferenda}.\footnote{Brunner (Germany) \[56].} Thus, here it is not so much that a failure to continuously adhere to 2% inflation or 3% deficits are manifestly incompatible with the European legal order and will immediately entail a withdrawal from EMU. Rather, it is that systems which fail to adhere to these conditions are manifestly incompatible with the European legal order. So, for example, as a matter of monetary economics, a failure to achieve budgetary discipline implies inflation or debt mutualisation, and this offends the right to property (Article 14 BL) and the right to vote (Article 38 BL) which are part of the constitutional identity in conjunction with Article 1 BL (Human Dignity) and Article 20 BL (the Democratic State) and are not amendable under Article 79(3) BL.\footnote{The right to property (Art 14, in conjunction with Arts 1 and 79(3) BL), is safeguarded by protecting money-holders against expropriation by inflation: Gauweiler I (Germany); Gauweiler III (Germany).}

Part II of this study applies these boundaries to the field of fiscal federalism and extracts two permanent constitutional requirements with which any model of European fiscal federalism must comply if it is to remain stable and permanent as a matter of law and economics: The European Union must, first, preserve Member State constitutional formulas for the exercise of fiscal sovereignty; and, second, it must expose Member State finances to individuated market discipline under hard budget constraints. These legal prescriptions for EU federalism have been demonstrated to be robust at each stage of this analysis. They are found to penetrate, in identical form, all three layers of the grounded-theory methodologies deployed in Chapters 1-4, and they are found to

\begin{footnotesize}
(Austria) \[104]-[105]. Finland: Opinion on the Six Pack (Finland); Opinion on the Six Pack II (Finland); Six Pack III (Finland).
\end{footnotesize}
withstand robust empirical examination under the positivist ‘economic analyses of the law’ methodologies deployed in Chapters 5-7. These findings are extracted as follows:

[1] The constitutional boundaries identified in this thesis are real, they are permanent, and, for the architects of European fiscal federalism, they are dangerous: Constitutional courts have stated (and demonstrated) that nascent machineries of fiscal federalism will be invalidated if they trespass on constitutional formulas for fiscal sovereignty or the boundaries of conferral, and the architects of fiscal union must take them at their word. A model of fiscal federalism constructed upon the divisions between EU and Member State legal orders risks being rent asunder by competing claims of constitutional and EU law.

[2] The constitutional principles extracted in this study are shown to condition and constrain the entire legal architecture in Articles 119-126 (ex Articles 4 and 98-104 EC) of Chapter 1, ‘Economic Policy’ in Title VIII of the TFEU at Maastricht. The principles of fiscal federalism theory inscribed in the Treaty for their achievement presented a theoretically sound constitutional consensus on fiscal sovereignty and market discipline as indispensable requirements for EMU.\(^{3134}\) The Bundesbank explains:

‘The founding principle of the euro area was to leave the responsibility for fiscal policy in the hands of each individual member state… As an incentive to establish sound budgetary policy, it was codified in the Maastricht Treaty that neither the Community nor the member states may be liable for or assume the debt of another member state. The consequences of unsound fiscal policy, for example in the form of rising financing costs due to risk premiums on interest rates, were meant to be concentrate on the member state in question and not shared between other countries in the currency union as would be the case with joint liability or a transfer union.’\(^{3135}\)

[3] Chapter 3 showed that the \textit{causa sine qua non} of the euro crisis is a severe mispricing of private and public debt caused by a failure of Articles 121-126 TFEU to induce markets to differentiate between sovereign borrowers under a (now realised) bailout expectation. The model did not fail because investors failed to appropriately price risk; it did not fail because of the accumulation of sovereign debt; it did not fail because of public-sector governance failure; and it did not fail due to the inability of the central authority to control the finances of its Member States. The model failed because markets (correctly) assessed that the ‘no bailout’ rule was non-credible, and (correctly) guessed that the EU would sooner re-write the Treaties than allow a Member State to default. The

\(^{3134}\) Weidmann (2013): ‘The framework of monetary union was quite coherent, it reflected well-established regulator policy principles, and the attempt was made to learn the lessons and no to repeat the errors of the past.’

failure of European fiscal federalism is a failure of EU institutions and EU law. As Rodden observes of the lessons of fiscal federalism:

‘It is not surprising that these crises are interpreted as failures of market discipline. Unsustainable borrowing took place in part because market actors (correctly) interpreted the higher-level government’s no-bailout commitments as not credible. It is just as appropriate, however, to interpreted them as failures of hierarchy. … The European Monetary Union has fallen prey to exactly the same problem, and it seems to be failing in an even more spectacular fashion. … [H]alf-hearted efforts at hierarchical regulation inadvertently undermined market discipline by sending significant signals about the central government’s lack of credibility. Moreover, the very act of attempting to regulate the borrowing of member states signals a certain level of responsibility.’

[4] Chapter 4 summarised the findings of Part I and provided directions for the positivist empirical methodologies of Part II.

[5] Chapter 5 classified the new model from the perspective of fiscal federalism theory and established its operational demands on the European legal order. It found that ‘fiscal union,’ as it is used by EU institutions in the Commission Blueprint and the Five Presidents’ Report, does not refer - as the literature on federalism does - to the existence of independent federal tax and spending competences (which model the EU already has). It refers to the centralisation of Member State tax and spending competences in the Union – or, as the Commission so puts it, to ‘a means to imposing budgetary and economic decisions on its members.’ The emergent model identified in this chapter supplants a legal pillar of decentralised fiscal federalism (an entrenched ‘no-bailout’ law) with a legal feature of unitary states: Centralised legal governance of economic and fiscal competences. Chapter 5 posed three operational hypotheses for the second half of the study:

[6] Financial assistance and centralised legal governance does not conform to the legal architecture in Chapter 1 ‘Economic Policy’ of Title VIII TFEU for the guiding principles of stable prices and fiscal discipline as a matter of law.

[7] Financial assistance and centralised legal governance does not conform to the criteria of hard budget constraints and market discipline, and therefore does not comply with the guiding principles of stable prices and fiscal discipline as a matter of economic fact.

[8] Financial assistance and centralised legal governance does not conform to the boundaries of EU law and Member State fiscal sovereignty.

3136 Stark (2013), 544-545 ‘The allegation that the Maastricht blueprint is flawed and that the institutional framework contains deficits is thus incorrect. What is correct is that the Maastricht concept was never fully implemented.’


3138 Commission Blueprint for a deep and genuine EMU COM(2012) 777 final (emphasis added).
[6] The first hypothesis is found to withstand robust doctrinal and positivist examination against the rulings of the ECJ and several Member State constitutional courts. When the sovereign debt crisis arrived, there was no legal competence and no institutions allowing either the Union or the Member States to share the burdens of the crisis, and Article 125 TFEU expressly precluded the possibility of bringing one into existence.\textsuperscript{3139} The ESM and OMT are constructed upon, rather than within, the boundaries between (Union) monetary policy and (Member State) economic policy, and one constitutional court has already ruled that the latter has exceeded the allocation of competences.

[7] The correlated hypothesis, that the new economic model is manifestly incompatible with the mandate for price stability and fiscal discipline binding on the mandate of EMU, also withstands robust analysis. The new model has institutionalised the dysfunctional market incentives of soft budget constraints identified in Chapter 3 as the \textit{causa sine qua non} of the European sovereign debt crisis. The ‘\textit{Pringle Hypothesis}’ is a demonstrable empirical failure.\textsuperscript{3140}

[8] The final hypothesis of this study, that centralised legal governance is manifestly incompatible with the European legal order, also withstands robust analysis. Fully seven out of eight legal machineries upon which the new ‘fiscal union’ depends are vulnerable to repudiation under an \textit{ultra vires} or constitutional identity ruling by at least one EU or Member State constitutional court.

This study concludes that the European Union has embarked upon a model of ‘fiscal union’ that is fundamentally incompatible with the European legal order. The constituent documents of Europe’s twenty-eight Member States do not only constrain exercise of public power under EU coordination instruments \textit{de lege lata}; they constrain the disposition of public power under any subsequent amendments to the EU Treaties \textit{de lege ferenda}. The boundaries of constitutional identity identified in this thesis cannot be erased or re-drawn with the determined flourish of 28 pens, because they are not in the hands of politicians at all. If the foundation-stones of the ‘fiscal union’ examined in Part II of this chapter continue to violate the essential conditions for European fiscal federalism set out in this thesis, the EMU will, with certainty, join its forbears in the dustbin of history. If it does not, it can only be because it has defied all that is known of law, economics and history, in order to be the first not to do so.

**Proposed Solutions**

This thesis concludes with two prescriptions. The first is that hard budget constraints and market discipline must be restored at all costs. It must be recalled that this is not merely because government debt is increasing (it is), but because yields on government debt set the basic cost of credit for the

\textsuperscript{3139} Edoardo Chiti and Gustavo Teixeira (2013), 698; Stark (2013), 543; Peroni (2013), 189, Articles 123-125 ‘excludes any form of financial and economic solidarity between EU member States’.

\textsuperscript{3140} See: Sections. 3.1.2 and 3.1.5.
entire economy. There is no clearer lesson to be extracted from this thesis than that there is no institutional counter to the inexorable pull of millions of private individuals responding, in their economic and political lives, to the dysfunctional incentives of cheap credit.

In that regard, the European Union must learn the same lesson that the US learned in 1840 and that Canada learned in 1936: As Maxwell and MacG so put it in the formative year of Canadian federalism, a federal state requires Member States to be ‘allowed to go broke at their own sweet will.’

Work on collective action clauses (CACs) under the bank-restructuring mechanism and the introduction of CAC’s into all Member State debt contracts under Article 12 TESM, are welcome steps and should provide the starting-point for further study.

Nevertheless, it must be recalled that creditor restructuring is unlikely under conditions of soft budget constraints. As the analysis of Germany in Section 7.2.1 informs, as long as the ‘federal’ economic constitution is read by markets as mandating the bail-out of sub-units, ‘threats by the federation to allow states to enter into a default or debt restructuring with private creditors have extremely limited scope.’ There is no sugar-coating the pill that must be swallowed: Someone, somewhere, at some time, must lose their money. In the European Union, this will have significant political implications: As noted in Section 3.2.1, ‘Cross-border credit flows’, the amount invested in Periphery countries by German banks exceeded their entire aggregate capital. However if the Union is not to follow the Canadian Dominion of 1867-1934, the US Federal Congress of 1788-1840, the German Reich of 1871 and the Weimar Constitution of 1920 into the dust-bin of federal arrangements, it must withstand the default of its individual members. As the Bundesbank concludes:

‘It is imperative that the no bail-out rule that is still enshrined in the treaties and the associated disciplining function of the capital markets be strengthened, and not fatally wounded.’

This is why credible legal enforcement of the treaties is needed. If the treaties are to be amended, this must only be to restore the ‘no bail-out’ rule. Fiscal federalism, being as it is concerned with the

3141 See: Chapter 3, Section 3.1.
3142 Zeitler (2014), 246: ‘During the last 10 years, it has become obvious that rules intended to limit deficits and debts will only be followed if supplemented by political and economic incentives.’ See also: Lane and McQuade (2013), 3; Tommasi and Weinschelbaum (2007);
3143 Maxwell and MacG (1936), 379.
3144 From 2013 onwards all EMU countries must imbue their debt contracts with CAC’s that make majority decisions among creditors possible, which then become binding on all other creditors. A country that appears to be insolvent must negotiate a comprehensive restructuring plan with its creditors. At 12(3) states: ‘Collective action clauses shall be included, as of 1 January 2013, in all new euro area government securities, with maturity above one year, in a way which ensures that their legal impact is identical.’ For analysis Sutherland, Price and Joumard (2005); Blankart and Klaiber (2006), 53; Seyd (2011), 432; EEAG, (2011), 84. For discussion of the operation of the bank restructuring mechanism, see: ECB, 'The European Stability Mechanism' (2011), 78-82.
3146 See: Infra, pp 171 ff.

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optimum decentralisation of democratic and economic goods, is one area inherently at tension with the logic of ‘ever closer union’ - which, taken to its logical conclusion, implies the centralisation of all decision-making power in one building.\textsuperscript{3148} It is specifically this teleology which informs the normative rejection of ‘absolute’ supremacy in Member State courts (see Section 1.2.2.2);\textsuperscript{3149} it is specifically this teleology that led the treaty drafters to replace Article 108 EC with the ‘no bailout’ rule (see Section 2.3.1.4); and, it is specifically this teleology that led investors to (correctly) calculate that the ‘no bailout’ rule was not credible (Sections 3.1.2-3.1.5). From the view of fiscal federalism theory, those in the European Legal Service which have called for the removal of Article 125 TFEU in order to eliminate the last irritants of fiscal sovereignty are fundamentally misconceived.\textsuperscript{3150} As Dabrowski complains: When weighed against the data on fiscal federalism, ‘the claim for closer political and fiscal union sounded more like a creed rather than something based on well-founded academic arguments.’\textsuperscript{3151}

The second proposal derives not from what this study says, but from what this study does not say. The thesis of this study is that any model of European fiscal federalism must (1) preserve the fiscal sovereignty of its constitutional democracies, and (2) it must have market discipline. This thesis does not state that a central fiscal capacity – a ‘fiscal union’ – of sufficient heft to perform a counter-cyclical role is incompatible with the European legal order. It simply states that the particular ‘fiscal union’ christened in \textit{Pringle v Ireland} and the ‘Five Presidents’ Report’ is incompatible with the European legal order.\textsuperscript{3152} The reason for this, as Hinarejos, Huber, Dawson and de Witte and others have similarly concluded, is that it requires the abrogation of the principle of conferral, upon which the constitutionality of Member State participation in the Union depends.\textsuperscript{3153}

However, it must also be recalled that, as noted in Section 5.2 of this study, the model of ‘fiscal union’ bandied-about by Union institutions is something of a perversion of the term. ‘Fiscal union’, according to the Commission Blueprint and the Five Presidents Report, does not refer, as the

\begin{footnotesize}
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\item \textsuperscript{3148} TEU, preamble: ‘RESOLVED to continue the process of creating an ever closer union among the peoples of Europe, in which decisions are taken as closely as possible to the citizen in accordance with the principle of subsidiarity.’
\item \textsuperscript{3149} See, \textit{infra}, Section 1.2.2.2, pp 75-76. According to Pescatore (1970), 174, has written, ‘the interpretation of Community Law depends not on the idea of maintaining an equilibrium which has been reached but on the vision of a European unity which is to be built.’
\item \textsuperscript{3150} Merino (2012) (n 1), 1632, ‘The rational of the [no bailout] prohibition, founded on the logic that Member Stats remain sovereign for their budgets, would not exist any more should euro area Member States no longer be sovereign for their budgetary decisions.’
\item \textsuperscript{3151} Dabrowski, 'Fiscal and Macroeconomic Governance' (2015), 5.
\item \textsuperscript{3152} Wolfgang Münchau, 'Better no fiscal union than a flawed one' \textit{Financial Times} (18 October 2015).
\item \textsuperscript{3153} Hinarejos, \textit{Constitutional Perspective} (2015); Hinarejos, 'Limits to Fiscal Integration' (2014), 263: ‘First, it has been shown that such an amendment, resulting in the creation of an fully fledged fiscal policy at the EU level, would weaken the principle of conferral as a mechanism.’ See also: Huber (2014) 9, 12: ‘If EU membership is based on national legislation, it seems to be inevitable that especially constitutional law may also set limits to European integration. In the end there are two limits to European integration derived from national constitutional law: (a) the national or constitutional identity on the one hand, and (b) the programme of integration on the other (b).’ Armstrong (2013): ‘the historic focus on constitutionalising and containing the Community method may well have produced a paradoxical mismatch between limited EU governance capacities and expanding EU normative ambitions.’ See also: Edoardo Chiti and Gustavo Teixeira (2013) and Jabko (2011): three constitutional conditions constraining EU fiscal union: no transfer union, no further competences, and no constraints on autonomy.
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literature does, to the existence of independent *federal* tax and spending competences (which model the EU already has). It refers to the co-option of *Member State* tax and spending competences by the Union – or, as the Commission so puts it, to ‘a means to imposing budgetary and economic decisions on its members.’

This is wrong. Nonetheless, it should be recalled that ‘constitutional identity’ does not mean that fiscal policy is absolutely and forever entombed at national level. It means that the powers identified under that jurisdiction must be exercised in accordance with the constitution’s unamendable structures; or, if they cannot be so exercised, then the impingement on those rights must not be so severe that it violates the constitutional democracy in its essential content. The three tests are:

[1.3.1.4] A restriction on budgetary sovereignty must not ‘fetter the budget legislature to such an extent that the principle of democracy is violated’, i.e., ‘with the effect that it or a future Bundestag can no longer exercise the right to decide the budget on its own’; and

[1.3.1.5] A disposition of budgetary sovereignty must not compromise the principle that ‘the German Bundestag remains the place in which autonomous decisions on revenue and expenditure are made’; and

[1.3.1.6] The decision must be reversible by an equivalent action by the Bundestag and the degree of the infringement must not be of structural significance to Parliament’s right to decide on the budget, such that ‘the democratic process remains open and that legal re-evaluations may occur on the basis of other majority decisions and that an irreversible legal prejudice to future generations is avoided.’

With certainty, this prohibits the co-option of *Member State* expenditure competences, and mutualisation of *Member State* revenue competences to finance them. It does not, however, prohibit the conferral of further expenditure and revenue competences on the Union, provided they ‘do not grant the European commission authority to impose specific substantive requirements for the structuring of budgets’ and do not deprive European constitutional democracies of the ‘substance of the power to rule.’

In that regard, the ‘classical’ model of fiscal federalism inscribed in the Treaty at Maastricht, and visible in Canada, the United States, and Switzerland, does not trespass on any of the tests set out in this thesis.

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3154 Commission Blueprint for a deep and genuine EMU COM(2012) 777 final (emphasis added).
3155 Kumm, ‘Final Arbiter’ (1999), 357-358; Preshova (2012), 283 (arguing that these principles are not absolute).
3156 Aid Measures for Greece (Germany) [104] and Re ESM I (Germany) [195]; Re ESM II (Germany) [161].
3157 Aid Measures for Greece (Germany) [124]. See also: Parliamentary Information (ESM & EPP) (Germany) [114].
3158 Re ESM II (Germany) [173].
3159 Re ESM II (Germany) [244].
Take Canada. The Federal Government and the Provinces both have extensive and overlapping tax and expenditure competences. Each citizen is subject to two separate and equal governments. A student of law in British Columbia (B.C.) will, for example, receive two expenditure packages of student funding: one from the federal government and one from her province. They will arrive in separate letters, offering separate amounts (each as they may afford), and she will pay them back separately. If the province goes broke, she may still rely on the federal, and vice-versa; but at no point will one of her governments transfer her funds to the other because it could not keep its commitments. Canada and B.C. may make mutual investments, such as in health care or highways, but these are assessed on their individual merits. Indeed, she controls them separately: She may vote to have one increase their spending and the other reduce it.

To fund her governments, she will pay 7% GST to the Federal Government and 7% PST to the Provincial Government. She may vote, as she did in 2006, to lower her federal tax to 5% if she prefers; and she may vote, as she did in 2011, against lowering her provincial tax to the same if she does not like the deal offered to ape the federal base. Her neighbours in Alberta have elected to levy 0% in PST, and they provide themselves less student grants. Farther away, Québec chooses to charge 9.975% QST (Quebec Sales Tax), and it charges few student fees at all.

Direct taxation works in a similar manner: if British Columbia should decide to compete with its low-tax neighbour Alberta by fine-tuning its tax base, it may do so, and the federal government will provide an ‘abatement,’ resiling its base on those factors to make room for the provincial taxing powers.3160 There are no recidivistic ‘CCCTB’ proposals coming down from dubious legal bases at federal level to co-opt or stamp-out tax competition in the Member States.3161

Applying the tests applied in this thesis, does this Canadian ‘fiscal union’ intrude on fundamental decisions on public revenue, expenditure and the shaping of the social state,3162 such that the B.C. legislature no longer ‘remains the place in which autonomous decisions on revenue and expenditure are made’?3163 Clearly it does not. Does the ‘overall responsibility, with sufficient political discretion regarding revenue and expenditure, still rest with the Provincial Legislature’?3164 Clearly it does. If the B.C. constitution were the German constitution, the entire ‘chain of legitimation’ between, the voter (Article 38(2) BL), exercising the right to vote (Article 38(1)(i) BL), for an autonomous parliament, free of other-directedness (Article 38(1)(ii) BL), possessed of the substance of the power to rule (Articles 20(2), 79(3) BL), would remain intact. Such an arrangement would not trespass on any of the tests set out in this thesis.

3160 Hogg (2013) 6-17.
3161 See: Gordon (2014).
3162 Aid Measures for Greece (Germany) [107], [122], [228] ; Re ESM I (Germany) [195]; Re ESM II (Germany) [161]-[165]; Parliamentary Information (ESM & EPP) (Germany) [114]; Re Lisbon (Germany) [228], [232].
3163 Re ESM I (Germany) [195]; Re ESM II (Germany) [161]-[165].
3164 Re Lisbon (Germany) [228]-[232]. See also: Aid [107], [127]; Re ESM I (Germany) [193]-[196]; Re ESM II (Germany) [161]; Gauweiler I (Germany) [28].
As regards the scale of such a transfer, Section 7.2.5.3 showed that in order to assign the EU a counter cyclical stabilisation role, the EU would need to be able to provide a total direct injection in its own spending competences (outlays plus revenue measures) of between 2-10% of Union GDP.\textsuperscript{3165} The 2009 US fiscal stimulus, for example, amounted to a total direct injection (outlays plus revenue measures) of $200bn, or 1.4% of GDP in 2009.\textsuperscript{3166} In Canada, the height of the 2009 federal stimulus reached nearly 4% of GDP.\textsuperscript{3167} This, too, would seem well within the tests for permissible constitutional dispositions under the German Basic Law. In \textit{Re ESM II (Germany)}, the Bundestag could dispose of huge sums - approximately 50% of all central government expenditure – without this constituting a complete or permanent failure of budgetary autonomy.\textsuperscript{3168} According to this thesis, such an arrangement would not fail any of the tests in this thesis – particularly if it is reversible by an equivalent action of the Bundestag in the future, (as British Columbia’s tax base is).

Is such an arrangement politically possible? It is not for this study to say. It seems unlikely, given the prevailing political climate. Supremacy will also prove an intractable problem, so long as allowing the EU its own tax base will inevitably result in challenging the autonomy of the Member States’ own. However, perhaps if there were not so many ‘back doors’ attempting to enter upon the exclusive expenditure/revenue competencies of Europe’s twenty-eight constitutional democracies, the peoples of Europe might be less unwilling to entrust the Union with its own.\textsuperscript{3169}

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\item[	extsuperscript{3165}] On the higher end, see: Dabrowski, ‘Fiscal and Macroeconomic Governance’ (2015), 11 (arguing that the fiscal capacity needed to carry out the roles assigned to it would need to amount to between 6-10% of Union GDP, encompassing ‘far-going tax schemes, social transfers, and other expenditure responsibilities.’); and OECD, \textit{Economic Surveys: United States} (2012), 85 (estimating 5-10%). On the lower end, Wolff (2012) for an annual Eurozone budget of 2% for the Union to play a counter-cyclical role. The MacDougall report called for a budget of 5-7% of GDP.
\item[	extsuperscript{3166}] OECD, \textit{Economic Surveys: United States} (2012), 85.
\item[	extsuperscript{3167}] OECD, \textit{Economic Surveys: Canada} (2012), 21.
\item[	extsuperscript{3168}] \textit{Re ESM II (Germany)} [173].
\item[	extsuperscript{3169}] See, e.g., Irish Taoiseach Enda Kenny referring to the CCCTB as ‘tax harmonisation by back door.’ Arthur Beesley, ‘Common EU corporate tax rate back to haunt Kenny’ \textit{The Irish Times} (<http://www.irishtimes.com/news/common-eu-corporate-tax-rate-back-to-haunt-kenny-1.447314>) accessed 25 January 2015; and two leaders of bailout recipient countries having openly referred to their bailout agreements as a ‘coup’: Lynch (2016).
\end{enumerate}
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