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Building on institutional failures: the European Treaty on Stability, Coordination and Governance

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Or : why the crisis in the Eurozone is so deep and persistent

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Abstract

The paper is devoted to an analysis of the Treaty on Stability Coordination and Governance (TSCG), also known as the “Fiscal Compact” Treaty signed between the EU member states in 2012. We argue than the TSCG, instead of helping to “repair” the institutional failures on which the Euro and the Eurozone are built, strengthens them and further weakens the construction on which the European member states operate. In this sense, the Treaty explains why the crisis in Europe is so deep and persistent, and why the member states of the Eurozone are having such difficulty in returning to a path of balance and growth. After defining the “core” of the Treaty more precisely, by describing the nature and significance of the new rules it has introduced in more detail, we explain why these rules create supplementary obstacles in the road to recovery.

Introduction: Why the TSCG is so important in explaining the current situation of the Eurozone

The “Treaty on Stability, Coordination and Governance” (TSCG), also known as the “Fiscal Compact”, was signed on March 2nd 2012 by the member states of the Eurozone. The Treaty has now entered into force for all 25 signatories.

I believe this short Treaty (only 15 articles) to be of capital importance, for several reasons:

- Firstly, because in its own way, it is meant to implement the lessons learned from the long crisis affecting the Eurozone, *by proposing major institutional changes in the “coordination” between member countries.* Thus, after long negotiations and under the decisive influence of Germany, the central provision (articles 3 to 8) sets out the principle of a “golden rule” that signatories are required to respect. This consists in an irrevocable commitment by member states “whose currency is the euro” to maintain their national budgets *in balance*, that is to say with a structural deficit not exceeding 0.5% of GDP. As we will see, this provision entails or is accompanied by several others.[1]

- Secondly because in substance, the Treaty effects three complementary changes which, taken together, radically alter the prevailing rules and practices in the Eurozone. These three changes are the following:

a) Firstly, significant tightening of the two series of constraints first set out in the Maastricht Treaty of 1991 and then codified in the Stability and Growth Pact (SGP) of 1999. The SGP committed the signatories (members of the Eurozone) to respecting a maximum budget deficit of 3% and a maximum public debt of 60% of GDP. The TSCG replaces the authorized limit of 3% by the *requirement to balance public finances*; 0.5% is the maximum allowed. And this threshold of 0.5% is itself

1 *In terms of form,* the TSCG is markedly different from its predecessor, the Treaty of Lisbon. It is short and easily readable, although, as is customary, some of the provisions can only be fully understood by referring to other treaties or rules in force within the EU or the Eurozone. The text of the Treaty, accompanied by documents that are useful for interpreting it, can be found on the European Union website.

evaluated on the basis of what is called the “structural” deficit.[2] As regards the rule limiting public debt to 60% of GDP, although the limit itself has not changed, the TSCG introduces strict rules of automatic reduction of the debt to bring it back down to 60%, which was not the case in the Treaty of Lisbon.

b) This leads to the second key change: the Treaty systematically introduces *the principle of automatic and obligatory corrections mechanisms to enforce respect of the new rules*. These correction mechanisms apply both to the budget deficit (the famous 0.5 %) and, as we have mentioned, *to the case where public debt exceeds the 60 % of GDP* specified in the SGP. Under the authority of the Commission, responsible for enforcing these programs of correction and return to balance, financial sanctions can be inflicted on member states who fail to respect these commitments. Indeed, one of the characteristics of this new Treaty is that it considerably strengthens the powers of the European Commission and of the European Court of Justice, to the detriment of the rights of national governments. As we will explain, herein lies one of the essential conceptual novelties of this Treaty: *the strengthened “coordination” between member states consists as far as possible in the application of common, uniform rules aiming to put economic policy on “automatic pilot”*. These rules are to “take effect in the national law of the Contracting Parties [...] through provisions of binding force and permanent character, preferably constitutional, or otherwise guaranteed to be fully respected and adhered to throughout the national budgetary processes” (Article 3.2).[3] It is most important to note that these measures are not intended as short-term

2 Without going into too much detail, the idea of structural deficit means that it is not the “instant” deficit that is measured at time *t*, but the deficit corrected for the economic factors that have influenced it upwards or downwards. The measurement of the “structural” dimension of the deficit (which can vary significantly according to the methodology used) is a complex question on which economists are divided. On this point, see the discussion in the book *L’Europe mal-traitée*, published by LLL, 2012.

3 In France, this article of the Treaty has been the subject of debate and interpretation. The *Conseil Constitutionnel*, asked to give its opinion on this point by the President of the Republic, ruled that there was no need to change the French constitution. Nevertheless, according to the very terms of the Treaty, the French government must introduce provisions as effective as constitutional change to ensure the permanent respect of these new rules. Remember that the Commission, and if necessary the European Court of Justice, will be called upon to verify that the measures introduced comply with the spirit and letter of the Treaty (see Article 3.2).

responses to a given economic situation, nor on a temporary basis. *These are permanent norms and mechanisms of budget balance* that are being introduced.

c) The most immediate effect of the adoption of these measures (even before their "constitutionalization", currently in progress) is the establishment, in all the member states, of programs of convergence towards rules of budget balance that have become the be-all and end-all of economic policy, which is now governed by this objective. For all these reasons, the Treaty – though small in terms of length and number of articles – has brought about major changes in the functioning of the Eurozone. After Maastricht and Lisbon, it marks the beginning of a third chapter in the history of the euro.

The final reason that has led us to focus on this Treaty is that, instead of helping to "repair" the institutional failures on which the Eurozone is built, it strengthens them and further weakens the construction, as we will explain below. In this sense, the Treaty explains why the crisis in Europe is so deep and persistent, and why the member states of the Eurozone are having such difficulty in returning to a path of balance and growth.

After defining the "core" of the Treaty more precisely, by describing the nature and significance of the new rules in more detail, we will examine the meaning that can be given to a Treaty that raises so many questions.

1. The core of the Treaty: the "golden rule" and the automatic triggering of correction mechanisms

It is Article 3.1 that formulates the essential changes introduced by the Treaty. Point (a) of this article stipulates that: "*the budgetary position of the general government of a Contracting Party shall be balanced or in surplus*". Point (b) *continues*: "*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, […] with a lower limit of a structural deficit of 0.5 % of the gross domestic product at market prices*". The tightening of the target is thus clearly affirmed. The same article, truly of central importance, also introduces the other major change: the principle of necessary convergence towards the objective of 0.5% and the "automatic" triggering of correction mechanisms in the event of deviation. On this point, the text stipulates: "*The Contracting Parties shall ensure rapid convergence [...]*" towards this objective. "*The time-frame for such convergence will be proposed by the European Commission [...]*" (point b). "*The Contracting Parties may temporarily deviate from their respective medium-term objective or the adjustment path towards it only in exceptional circumstances [...]* (point c). "*In the event of significant observed deviations from the medium-term objective or the adjustment path towards it, a correction mechanism shall be triggered automatically. The mechanism shall include the obligation [...] to implement measures to correct the deviations over a defined period of time*" (point e).

As a result of these provisions, the "golden rule" is built on three pillars: i) the principle of balanced public finances (with a tolerance of 0.5 % of GDP) becomes a supranational commitment written into a European treaty; ii) any deviation from the balanced budget triggers automatic correction procedures; iii) these procedures are supervised by the European Commission. The imposition of this golden rule calls for a number of observations.

For the member states of the Eurozone, it introduces *an additional and inescapable rigidity within a system that already contains several rigidities*. Remember that within the Eurozone, national governments control neither *the interest rate*, nor the *exchange rate* (which are both fixed by the combined actions of the European Central Bank and the markets). Depriving governments of the little room for fiscal maneuver that still remained to them to respond to unforeseen events thus appears as a new infringement on the independence of national policies. It severely reduces the scope for action and adaptation - already very narrow - available to governments to deal with the persistent crisis that has afflicted Europe since 2007.

The principle of imposing *a single, identical rule on all the member states* is also questionable. This principle of unicity is in flagrant contradiction with the essential diversity of the national economies of the countries in the Eurozone. It denies the diversity of national trajectories, the importance of history and the fact that different economies may (and often *should*) follow different paths, adapted to their specific constraints and resources.

Lastly, this balanced budget rule *is absolutely devoid of any economic foundation*. No established theory supports such a rule. On the contrary, the idea that in a recession, running a budget deficit is an appropriate (and often necessary) way to restore equilibrium has been well-argued, notably in the Keynesian doctrine which long dominated the large economies of the developed world. According to Keynesians, the multiplier effect of public spending, if it is well thought-out and correctly applied, can boost tax revenue with the return of growth, and thus improve the budget situation.

More generally, by allowing no exceptions in terms of the nature of government spending, this rule denies the fact that some expenditure (and/or forms of debt) can be eminently productive, by preparing future revenue. Such public spending aims to strengthen positive externalities (or create new ones), by investing in research, education, communications or transport, for example.

It is also worth noting that the imposition of this balanced budget rule is *unique to the Eurozone*: none of the large economies around us have adopted such a constraint. And in the past, such rules have never been respected, either within or outside Europe.[4] Moreover, within the Eurozone, *the 3% rule previously in force was never respected either, although it was a lot less restrictive*: in 2004 and 2005 both France and Germany chose to infringe it, bringing their full weight to bear on the Commission to avoid being penalized for this transgression.

As far as the public debt is concerned, the change effected by the Treaty is also of considerable significance. The new rule is stipulated in Article 4 of the Treaty. Although the reference value of 60% of GDP specified in the SGP has not changed, what is new is the *obligation imposed by the TSCG to reduce the debt in excess of 60% by at least one twentieth every year*. Failing which, the state concerned, declared to be “at fault”, must make a deposit with the ECB, which could turn into a fine of considerable size, ranging from 0.2 to 0.5 % of the GDP of the state in question.

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Once again, the reference value (here 60%) has no serious economic foundation. It is a pure convention (fixed when the SGP was being drafted), all the more debatable for being applied uniformly to all the member states, whatever their domestic saving rate or tax capacity.

If we also take into account the recessionary effect that *the combination of the two rules* (budget deficit at 0.5% and public debt at 60%) cannot fail to have, it is clear that this new Treaty is very likely to have the opposite to the intended effect: it will move national economies away from the desired equilibrium instead of bringing them closer to it. A recent study by three independent economic research institutes, IMK (Germany), OFCE (France) and WIFO (Austria), evaluating the impact of the austerity policies induced by the Fiscal Compact,[5] concluded that between 2010 and 2013, the measures entailed by implementation of the Treaty caused a reduction of 7 percentage points in the GDP of the Eurozone.

2. The TSCG as an instrument for reforming the "Community of Fiscal Stability"

In the light of all these factors, one might reasonably wonder why these rules have been imposed. The answer to this essential question is complex, and lies on two different levels.

On one level, the choice of these new rules is a tacit acceptance of the idea that the crisis afflicting the Eurozone *is not primarily the result of deregulated, globalized finance, but a problem of public finances*. Without regard for the undeniable facts, in particular that the explosion in public debts and deficits *was subsequent to and a direct result of the financial crisis of 2008-2010*,[6] the implicit idea underpinning the Treaty is that the main threat to the Eurozone stems from the existence of national governments that are "overindulgent" and living beyond their means. Consequently, the "disciplining" of these governments is seen as the solution to the crisis. The implications of this view are well-known. It calls for budget cuts applied both to the number and pay of public employees and to social

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spending (pensions, health, benefits, etc.) with the risk, as explained above, that the recessionary impact of these cuts will create an endless vicious circle. The examples of Greece, Spain and Italy are there to remind us that this is not just a theoretical hypothesis. Quite apart from the highly questionable nature of the idea that the current crisis was caused by excessive public spending,[7] the solution proposed by the Treaty is very paradoxical. From the observation that member states have not been able to respect the 3% limit, the conclusion has been drawn that a limit of 0.5% will be more likely to succeed. As if tightening a constraint that it had been impossible to respect in the past might increase the chances of success in the future!

Therefore, if we are to understand the motives behind the adoption of these new rules, we must move beyond the idea that the sole objective of the Treaty is to rectify excessive spending by member states of the Eurozone. To this end, we must return to the discussions (and oppositions) that marked the formation of the Economic and Monetary Union and the adoption of the euro.[8] The essential point here is that at the end of the 1990s, when the establishment of a European monetary zone was being discussed, everyone knew that monetary union could not exist between countries with such disparate economies as Greece, Germany or Ireland, for example, without the *active coordination of economic policies*, that is to say without a veritable *common budget* and without *transfers* between the regions and countries within the future monetary zone. Despite these obvious facts, the choice was made from the very beginning to limit this common budget to the minimum (and in truth, well below the minimum: about 1% of European GDP), to leave economic coordination without status or effectiveness, and to limit transfers to levels far below what is really needed.

Consequently, and under the pressure of Germany, who pushed this point of view forcefully, the idea that prevailed and was embodied in the signing of the SGP was, for lack of any real coordination or budget, *to require each member state individually to shoulder the responsibility of budget balance*. The implicit idea was that if each state is in balance, then there is no need for coordination, common

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budget or transfers. *So the monetary zone was created, but it was believed that by applying this budget balance rule to each state, it would be not be necessary to establish the conditions to make it possible.* Such was the construction thought up by the architects of the Eurozone. In the jargon of the EC, this construction was given a name: following a German proposal, the aim was to build a “community of fiscal stability”. “Community” because the euro is the single currency of all the member states, and “of fiscal stability” because it is the responsibility of each state to ensure the respect of its own specific budget balance. This is the view that the SGP was intended to embody. The two rules that it imposed on each member state (a maximum budget deficit of 3% and maximum public debt of 60% of GDP) were meant to guarantee the stability of the Eurozone *while depriving it of any real economic coordination*. Likewise, Article 123 of the Treaty of Lisbon, which prohibits the ECB from acquiring any government bonds, and Article 125, which excludes the possibility of any solidarity between member states in the event of a crisis in one of them, can only be interpreted in this light: *the Eurozone is not built on solidarity, but on the individual responsibility of member states, each obliged to achieve their own budget balance.*

Of course, it is this institutional construction that was exploded by the financial crisis. But even without that particular crisis, the result would have been identical and inevitable, because over the course of time, the inequalities between countries within the Eurozone have widened, without any real correction mechanism to counteract them. Consequently, the countries whose competitiveness has declined (or even totally collapsed), deprived of the central instrument of adjustment previously available in the form of devaluation of the national currency, are sure to founder. Greece provided a spectacular example of this phenomenon, before Portugal, Spain and Italy followed suit, to a lesser degree.

So the financial crisis has simply accelerated a development that was already under way. It has served to remind us of this essential truth: one cannot build a monetary zone without economic coordination, common budget or active policy of transfers to contribute to the convergence of the countries and regions within the zone. The paradox of the TSCG is that it seems as if, instead of acknowledging *the* *failure of the implicit concept on which the Eurozone was built* and seeking to restructure the Economic and Monetary Union on fresh institutional foundations, the European leaders have seized the opportunity presented by the crisis not simply to reaffirm a rule that has already proved its futility, but to strengthen it yet further by changing from a minimum deficit of 3% to a minimum "structural deficit" of 0.5% and giving this rule maximum force by making it quasi-constitutional.

Likewise, instead of making up for the failure of coordination between states that has been so outstandingly apparent throughout the crisis, by setting up mechanisms of consultation and deliberation in bodies endowed with real decision-making powers, the new Treaty, in terms of coordination, has established (or strengthened) *automatic mechanisms for restoring budget balance*. By placing the enforcement of these procedures under the authority of the European Commission, with powers of sanction, it is hoped that the rules that were not respected in the past will be respected in the future. The defunct "Community of Fiscal Stability" that the SGP purported to impose and that the financial crisis shattered has thus been born again with the new Treaty, like a phoenix rising from the ashes.

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All in all, the TSCG, far from rethinking an institutional architecture that has proved to be a failure, in order finally to provide the Eurozone with suitable foundations, appears above all as an attempt to "toughen up" the mechanisms and standards whose immense failings have been revealed by the financial crisis, without modifying either their nature or their spirit.

We believe that this goes a long way to explaining the current difficulties of the Eurozone and the inability of most member states to extricate themselves from the crisis. If the Eurozone is to survive, other institutional devices than those currently in force must be introduced, to modify certain essential points in the type of governance imposed by the new Treaty. Far from helping to solve the problems raised, this Treaty simply exacerbates them.