

The Effectiveness of EU's Fiscal Rules Can Only Be Ensured by the Member States

Citation for published version (APA):

Cuomo, A., & Nicolaidis, P. (2023). The Effectiveness of EU's Fiscal Rules Can Only Be Ensured by the Member States: Reflections on the Ruling of the Federal Constitutional Court on Germany's Budget. *EU Law Live*, (168), 1-10. <https://eulawlive.com/weekend-edition/weekend-edition-no168/>

Document status and date:

Published: 01/12/2023

Please check the document version of this publication:

- A submitted manuscript is the version of the article upon submission and before peer-review. There can be important differences between the submitted version and the official published version of record. People interested in the research are advised to contact the author for the final version of the publication, or visit the DOI to the publisher's website.
- The final author version and the galley proof are versions of the publication after peer review.
- The final published version features the final layout of the paper including the volume, issue and page numbers.

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DECEMBER 23

2023

N°168

Weekend Edition



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PHEDON NICOLAIDES AND ALESSANDRO CUOMO

**THE EFFECTIVENESS OF
EU'S FISCAL RULES CAN
ONLY BE ENSURED BY
THE MEMBER STATES:
REFLECTIONS ON THE RULING
OF THE FEDERAL
CONSTITUTIONAL COURT ON
GERMANY'S BUDGET**

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The Effectiveness of EU's Fiscal Rules Can only be Ensured by the Member States: Reflections on the Ruling of the Federal Constitutional Court on Germany's Budget

Phedon Nicolaides¹ and Alessandro Cuomo²

Introduction

A year ago the European Commission initiated discussion on the EU's fiscal rules with its Communication on orientations for a reform of the EU economic governance framework.³

The Council of the EU adopted most of the core ideas of the Communication on 14 March 2023. Although so far no agreement has been achieved on the details, Member States appear to accept that, among other things, the limit of 3% of GDP for budget deficits defined in the Treaty on the Functioning of the European Union [TFEU] will be kept, enforcement should be made more effective and Member States should take ownership of necessary reforms and decisions on sanctions for breaking fiscal rules.⁴

That these issues are still being discussed is not surprising, given that Member States even before the pandemic routinely exceeded the 3% threshold for budget deficits [and the limit of 60% of GDP for public debt]. From another perspective, the discussion on these issues is indeed surprising given that the vast majority of EU Member States have acceded to the Treaty on Stability, Coordination and Governance [TSCG] which lays down even stricter limits and urges Contracting Parties to enshrine those limits in their constitutions.⁵

The purpose of this Long-Read is to argue that the recent decision of the German Federal Constitutional Court [FCC] on Germany's supplementary budget demonstrates that in addition to rules, the EU also needs sensible national procedures.

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3. See Commission Communication on orientations for a reform of the EU economic governance framework, [COM\(2022\) 583 final](#), 11 November 2022.

4. See [Council Conclusions of 14 March 2023](#). See also [Council Press Release](#) of 14 March 2023.

5. The TSCG can be accessed [here](#).

Why rigid rules?

Pursuant to its Article 1(1), the purpose of the TSCG is to ‘strengthen the economic pillar of the EU Economic and Monetary Union’. Its Title III seeks to improve the solidity of the Contracting Parties’ public finances through the introduction of rules on budgetary discipline in national legal frameworks.

In particular, Article 3 of the TSCG aims to preventively limit the recourse of national governments and parliaments to excessive deficit as a tool to fund public policies. Paragraph (1) of the Article stipulates that the annual budgets of Contracting Parties be balanced or in surplus and any deficit not to exceed 0.5% of GDP. In order to ensure that Contracting Parties comply, Article 3(2) requires that ‘the rules set out in paragraph 1 shall 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.’

The purpose of Article 3(2) of the TSGC is to provide an inflexible constraint of constitutional nature to the ability or inclination of governments to run budgetary deficits. The government of the day should not be able to run a deficit which will unavoidably create a problem of mounting debt for the next government.

However, deviations from the ‘0.5%’ rule are permitted in ‘exceptional circumstances’ which are defined by Article 3(3) as ‘an unusual event outside the control of the Contracting Party concerned which has a major impact on the financial position of the general government or to periods of severe economic downturn as set out in the revised Stability and Growth Pact, provided that the temporary deviation of the Contracting Party concerned does not endanger fiscal sustainability in the medium-term.’



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Therefore, an exceptional circumstance is an event that has the following features. It must be i) unusual, ii) outside the control of a Contracting Party, and iii) must have a major impact on public finances. The deviation from the 0.5% rule must be i) temporary and ii) must not endanger fiscal sustainability.

Germany was the most fervent supporter of a so-called ‘constitutional brake’ on budgetary deficit. Yet, on 15 November 2023, the FCC held, in case 2 BvF 1/22, that the Second Supplementary Budget Act 2021 was incompatible with Article 109(3), Article 110(2) and Article 115(2) of the German constitution [‘Basic Law’] that had incorporated the provisions of the TSCG.⁶

What does the Basic Law require?

Article 109(3) of the Basic Law lays down the principle that ‘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. ... Details for the budget of the Federation shall be governed by Article 115.’⁷ Article 109(3) of the Basic Law incorporates the conditions for emergency borrowing established by Article 3(3) of the TSCG.

Three aspects of Article 109(3) of the Basic Law should be noted. First, the prohibition of deficits is not absolute because budgets have to be balanced ‘in principle’. Second, a deviation is allowed in certain circumstances such as natural disasters or emergencies. Third, the precise process of a deviation from balanced budget is laid down in Article 115 of the Basic Law.

Article 115(2) defines limits for borrowing and a procedure for defining a deviation. Accordingly, ‘revenues and expenditures shall in principle be balanced without revenue from credits. This principle shall be satisfied when revenue obtained by the borrowing of funds does not exceed 0.35 per cent in relation to the nominal gross domestic product. ... The regulation of details, ..., requires a federal law. In cases of natural catastrophes or unusual emergency situations beyond governmental control and substantially harmful to the state’s financial capacity, these credit limits may be exceeded on the basis of a decision taken by a majority of the Members of the Bundestag.’

Article 115(2) lays down a deficit threshold that is lower or stricter than the 0.5% limit defined in the TSCG. That stricter threshold may be exceeded only in the case of natural disasters or emergency situations and only after a decision of the Bundestag.

Lastly, Article 110(2) of the Basic Law establishes that the ‘budget for one or more fiscal years shall be set forth in a law enacted before the beginning of the first year and making separate provision for each year’.

6. An English summary of the main points of the judgment is provided by the FCC itself. It can be accessed [here](#).

7. Germany’s Basic Law can be accessed [here](#).


Why did the FCC strike down the second supplementary budget?

According to the FCC's press release 101/2023, the subject of the FCC's judicial review was the Second Supplementary Budget Act 2021, that the German Bundestag had adopted to amend the federal budget for 2021. The main purpose of the Second Supplementary Budget was to repurpose a total of EUR 60 billion, already authorised in the federal budget for 2021, to the Energy and Climate Fund (then renamed the Climate and Transformation Fund). The source of the repurposed envelope of EUR 60 billion in the federal budget, however, consisted of additional federal borrowing in excess of 0.35% of GDP for the fiscal year 2021. That additional borrowing was authorised by the Bundestag with the First Supplementary Budget Act 2021 in accordance with Article 115 of the Basic Law. In a nutshell, the Bundestag's justification for the emergency borrowing in the First Supplementary Budget was to address the exceptional needs arising from the COVID-19 pandemic. However, there was no mention of any intention to fund the Energy and Climate Fund. At the end of the 2021 fiscal year it became apparent that the additional borrowing had not been used. Consequently, the Second Supplementary Budget Act repurposed retroactively, in February 2022, for the then concluded 2021 fiscal year, the EUR 60 billion to the Climate and Transformation Fund.

**With the Second
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In essence, with the Second Supplementary Budget Act the Bundestag tried to hit two birds with one stone. First, the law attempted to make use of an already authorised, but untapped, envelope of emergency funding for a purpose different than the one established in the original authorisation law. Second, the law practically sought to issue EUR 60 billion of federal debt in 2022 without having such debt counted towards the borrowing limit for the fiscal year 2022, on the basis of the argument that such borrowing had been authorised for the fiscal year 2021.

The FCC held that 'the Second Supplementary Budget Act 2021 does not satisfy the constitutional requirements for emergency borrowing' for the following three reasons. 'First, the legislator failed to sufficiently demonstrate the necessary factual connection between the emergency and the crisis management measures taken in response. Second, decoupling the declaration of an emergency pursuant to Art. 115(2) sixth sentence of the Basic Law from the actual use of the borrowing authorisations is incompatible with the constitutional principles of yearly budgeting (*Jährlichkeit*) and annuality (*Jährigkeit*). The de facto unlimited use of emergency borrowing authorisations in subsequent fiscal years without counting them towards the "debt brake" rule (*Schuldenbremse*) for those years, and instead counting them as "debt" for the 2021 fiscal year is therefore impermissible. Third, the adoption of the Second Supplementary Budget Act 2021 after the end of the 2021 fiscal year violates the principle set out in Art. 110(2) first sentence of the Basic Law that the budget must be determined in advance (*Vorherigkeitsgebot*).'



A government cannot exceed the deficit threshold at will. It must justify why an emergency necessitates borrowing that exceeds that threshold and it must also demonstrate that the borrowed funds are used to remedy the impact of the emergency

What is interesting for the purposes of this Long-Read is the FCC's findings that, first, there must be a link between an emergency and the need for borrowing and, second, funds borrowed for emergency purposes must be used to address that particular emergency.

It is, therefore, clear that a government cannot exceed the deficit threshold at will. It must justify why an emergency necessitates borrowing that exceeds that threshold and it must also demonstrate that the borrowed funds are used to remedy the impact of the emergency.

Yet, the press reported a week after the FCC ruling that Germany was planning a vote in the Bundestag to suspend the 'debt brake' for a fourth year.⁸ Even if the Bundestag musters a majority in favour of the suspension, it must also provide sufficient explanation why the pandemic necessitates borrowing to fund environmental and transition measures. If the FCC is petitioned to review the legality of any new authorisation, it may still disagree with the claimed causal link.

Indeed, the FCC in its ruling of 15 November held that 'a factual connection is necessary between the natural catastrophe or unusual emergency situation on the one hand, and the exceeding of credit limits on the other. In assessing whether such a connection exists, the legislator has a wide margin of assessment. The Federal Constitutional Court does not conduct a review of the proportionality of the emergency borrowing. Nevertheless, the legislator has a burden of substantiation to make it possible for the Federal Constitutional Court to review whether the legislator's decisions on borrowing are plausible and tenable.'

8. Financial Times, "Germany to Suspend Debt Brake for Fourth Year Running", 23 November 2023.

At first sight, it would appear that proving that a decision is ‘plausible’ and ‘tenable’ is not a difficult task at all, given the legislator’s ‘wide margin of assessment’ and the non-application of the principle of proportionality to emergency borrowing. However, the FCC also observed that ‘the COVID-19 pandemic had already been in existence for almost two years. The longer ago the event triggering a crisis occurred – thus allowing the legislator more time for decision-making – and the more indirect the effects of a crisis are, the narrower the legislator’s margin of assessment becomes. This also entails stricter requirements regarding the legislator’s burden of substantiation, all the more so when the legislator – as in the present case – makes use of the possibility of emergency borrowing repeatedly within a fiscal year or in consecutive fiscal years.’ It is not only the causality between the emergency and the needs of the economy that wanes as time passes. It is also the continuation of the government’s response to the emergency with the same policy instruments. That is why, ‘the longer a crisis goes on and the more extensively the legislator has made use of emergency borrowing, the more detailed reasons the legislator must give as to why the crisis continues and why its planned crisis management measures continue to be suitable. In particular, the legislator must demonstrate whether the measures taken by the legislator in the past were effective and whether it has drawn conclusions for the suitability of future measures.’

If Germany is to continue with the same policies, it must also show that they remain suitable and effective. This is a new test that goes beyond a demonstration of causality. The reasoning of the FCC was, in essence, that if throwing money at a problem did not resolve it, then borrowing more and continue with the same policy would probably be ineffective as well.

What lessons can be drawn from the FCC’s decision for standards of review of budgetary policies?

The reasoning of the FCC was, in essence, that if throwing money at a problem did not resolve it, then borrowing more and continue with the same policy would probably be ineffective as well

The need to subject budgetary policy, and in particular excessive borrowing that augments public debt, to strict legal rules has been long advocated.⁹ Budgetary policies and debt sustainability are in many respects amenable to objective evaluation, and they can thus be ‘rationalised’ through the creation of constitutional limits binding on governments and parliaments. Where to draw those limits and to what extent they can be reviewable by courts, however, remain highly controversial issues.

There is hardly any doubt that governments should be allowed to issue debt in emergency situations. Borrowing in times of crises can be the only means of effectively stabilising macroeconomic shocks, such as the global financial crisis of 2008-2010, the COVID-19 pandemic and the spike in energy prices resulting from the Russian invasion of Ukraine. However, the tendency of governments to borrow and spend beyond their means even in the absence of crises is a threat to budgetary sustainability. In the EU, and in particular

9. See, for example, Nicholas Gruen, Making Fiscal Policy Flexibly Independent of Government, *Journal of Policy Analysis and Reform*, 1997, vol. 4(3), pp. 297-307.

in the Economic and Monetary Union, Member States' budgetary sustainability is not only a 'national' public good, but also a 'European' one. The TSCG, in this sense, can be regarded as the 'constitutionalisation' of rational budgetary policy which includes restrictions on a government's borrowing and, at the same time, exceptions under certain conditions in cases of emergencies.

The relevance of the FCC's judgement to the ongoing discussion on reform of the EU's fiscal rules is that it demonstrates that an effective fiscal framework does not only need clear European rules. Some form of control and analysis is necessary to implement such rules at national level. Case 2 BvF 1/22 constitutes the first instance, known to us, of national judicial review of a Member State's compliance with national rules implementing Article 3 of the TSCG. As Article 109(3) of the Basic Law largely incorporated the requirements for emergency borrowing enshrined in Article 3(3) of the TSCG, the judgement sets a precedent that could be studied – or replicated – by other national courts, when their jurisdiction permits so. Three lessons may be drawn for reform of national procedures implementing European fiscal rules.

First, case 2 BvF 1/22 has demonstrated that judicial review can strengthen compliance with European fiscal rules. However, judicial proceedings can take a long time before they are concluded. For this reason, any meaningful reform of the EU's fiscal rules should also look into removing obstacles to speedy national judicial procedures on budgetary matters. At the same time, judicial review always remains a remedy of last resort. As proposed in the Commission Communication of November 2022, other national institutions could be endowed with the power to review budgetary plans. Such institutions should be independent and entrusted with powers to stop non-compliant spending.

Second, institutions in charge of assessing national budgetary plans need to develop meaningful standards of review. In this respect it is rather interesting that the FCC explicitly stated that its review was not based on a proportionality test. In general, a proportionality test comprises three components: suitability, necessity and proportionality *strictu sensu*. Despite the FCC's statement, however, the language of its press release evokes the analytical framework of what may be called a 'light' proportionality test. Demonstrating the factual connection between the emergency and the need for exceptional borrowing looks like the 'necessity test' in the proportionality principle as expounded by the Court of Justice of the EU.¹⁰ In fact, the FCC goes further. When it specifies that the requirement for justification become stricter as the crisis becomes more distant in the past, it essentially establishes a presumption that the longer ago the crisis happened, the less of an emergency emanates from that crisis. Overall, the FCC seems to apply a 'reasonability check', as it asks the Bundestag to 'substantiate' how its decisions on borrowing are 'plausible' and 'tenable'.

In addition, the FCC appears to require what looks like a 'suitability test'. The justification for emergency borrowing must also be based on an assessment of the effectiveness of the extra funds. Governments and parliaments in the EU should carry out some kind of impact assessment before they embark on emergency borrowing and emergency spending. It is interesting to note that the application of a rationality check to EU Member States' budgetary policy would seek the same outcome as the reform of the EU fiscal rules proposed by the Commission. Both the check and the reform would spur 'a greater debate at national level'¹¹ and thus 'a higher degree of political buy-in and ownership' of budgetary policy and emergency borrowing.

10. See, for example, [C-62/14, Gauweiler](#), EU:C:2015:400, para. 67 and [C-343/09, Afton Chemical](#), EU:C:2010:419, para. 45.

11. Commission Communication on orientations for a reform of the EU economic governance framework, op. cit.

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Third, there should be limits to the review of budgetary plans and emergency borrowing. Courts or independent bodies should not second-guess or excessively restrict political discretion of legislators. In this respect, the FCC is right in clarifying that the legislature enjoys ‘a wide margin of assessment’ to draft special budgets authorising emergency borrowing beyond the minimum thresholds. At the same time, the FCC asks the legislator to demonstrate ‘whether the measures taken [...] in the past were effective and whether it has drawn conclusions for the suitability of future measures’ before authorising new emergency borrowing. But the decision whether new borrowing can effectively remedy the harm caused by a crisis will need to balance conflicting objectives and will likely be based on subjective judgment. The German Second Supplementary Budget provided a clear-cut case of a Member State’s legislature violating Article 3 of the TSGC. Shifting emergency borrowing originally authorised for fighting the COVID-19 pandemic into a climate fund without justification clearly falls foul of the preventive rationale of that Article 3 TSGC. The FCC was right in quashing the law. In less clear-cut cases, however, EU or national courts or independent bodies may not have sufficient information or objective grounds to object to emergency borrowing plans.

Shifting emergency borrowing originally authorised for fighting the COVID-19 pandemic into a climate fund without justification clearly falls foul of the preventive rationale of that Article 3 TSGC

The recent history of the FCC’s case-law can, perhaps, offer relevant insights on where the limits to review should lie. In case 2 BvR 859/15¹², the FCC reviewed the exercise of the ECB’s discretion in designing the ‘Public Sector Purchase Programme’ and concluded that the ECB exceeded both its discretion and competence under EU law. One of the main criticisms levelled at the judgement was that the standards of review used by the FCC to review the ECB’s programme were so high to appear, in themselves, discretionary.¹³ To avoid similar criticism, the standards of review of budgetary policy should not exceed the boundaries of a reasonability check, so that the review itself remains reasonable.

12. 2 BvR 859/15, 2 BvR 980/16, 2 BvR 2006/15, 2 BvR 1651/15.

13. See, for example, Matthias Wendel, Paradoxes of Ultra-Vires Review: A Critical Review of the PSPP Decision and Its Initial Reception, *German Law Journal*, 2020, vol. 21(5), pp. 979-994.



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