GOVERNMENT DEFICITS AND INVESTMENTS: A EUROPEAN LEGAL FRAMEWORK

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Abstract

In the academic and institutional debates concerning the role of the European Union with regard to national budgetary policies, there is an increasing concern for the limits that the EU has imposed on government debts and deficits. Much has been written, especially in economic literature, about the conventional nature of such limits. While this literature contains some useful insights, it will be argued that two central aspects of the topic have been insufficiently examined and only partially understood: one is the rule concerning government expenditure for investments, the other is its connection not only with the 'guiding principle' according to which financial conditions must be sound, but also with the common constitutional tradition which is reflected in such principle, that is to say financial stability. It will be argued, therefore, that the critique according to which the EMU has a negative impact on national policies aiming at financing investments is neither normatively nor empirically sound.

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1. Dilemmas of Government Deficits

There is little doubt that the development of a European legal framework for government debts and deficits has been one of the most significant achievements of the Economic and Monetary Union (EMU), whilst being one of the most controversial ones.

According to its advocates, such legal framework is a necessary element in the strategy of the European Union (EU) to ensure that government failures do not preclude a more integrated Europe. It has provided a set of common principles, standards, and legal procedures, though respecting the requisites of subsidiarity ([1]). At the same time, it has provided national policy-makers with an important, additional strength in order to overcome the opposition of vested interests to the necessary reforms of government policies, especially those that have a stronger impact on public expenditure, in the logic by which the EU serves to rescue the States from their weaknesses ([2]).

[1] S. Cassese, *La nuova costituzione economica* (1994), 145.

[2] For this line of reasoning, see A. Milward, *The European Rescue of the Nation – State* (2000, 2nd ed.).

For other commentators and political leaders, the EU legal framework, in particular for its component concerning government debts and deficits, is intrinsically flawed, because it codifies debt-reduction policies. The underlying assumption is, first, that as a matter of principle no constitutional provision should codify a certain vision of political economy ([3]). Second, debt-reduction policies sooner or later imply constraints on public expenditure, with a huge and negative impact on social programs ([4]). A variant of this argument is that EU rules weaken the rights, especially social rights, recognized by national constitutions and statutes ([5]). Another variant, and a very questionable one, is that EMU has a negative impact on national policies aiming at financing infrastructures, thus reducing the capacity of the Union as a whole to face the economic and financial crisis.

This article will seek to explore why and how the EU has imposed certain limits on government debts and deficits. Much has been written, especially in economic literature, about the conventional nature of such limits. While this literature contains many useful insights, it will be argued that two central aspects of the topic have been insufficiently examined and only partially understood.

2. Government Deficits in Economics, Political, and Legal Theories

An interesting way to introduce the discussion concerning government deficits can be that of pointing out, first, how the substantial convergence of views between lawyers and economists at the end of the Nineteenth century was modified by Keynesian theories and, second, how the budgetary policies that allegedly followed such theories raised a number of difficulties. This will

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[3] For a thorough discussion of this argument, see A. Wildavsky, *How to Limit Government Spending* (1980).

[4], But see V. de Rugy, *Is Austerity the Answer to Europe's Crisis?*, 33 *Cato Journal* 244 (2013) (observing that debt-reduction packages are dominated either by tax increases or by spending restraints).

[5] This is not only a sort of leit-motiv in legal literature, especially in field of constitutional law. It is a topic increasingly referred to by public institutions: see the European Economic and Social Committe's opinion "*Pour une dimension sociale de l'Union économique et monétaire*" (doc. n. 1566/2013).

provide a basis for understanding the rationales underlying the legal principles that regulate government deficits.

A) Infrastructures and Deficits in Adam Smith's Wealth of Nations

Without going too far in the history of ideas, the roots of the traditional thoughts about the role of governments in the economy can be found in Adam Smith's *Wealth of Nations*, one of the most influential works of Western civilization. Though emphasizing the virtues of markets, Smith did not neglect the role of the Sovereign. He identified three kinds of activities that could be regarded as being inherently public functions ([6]). While the first function concerned the protection of citizens against external and internal threats, that is to say defence and order, and the second consisted in the administration of justice, the third regarded public works. Smith focused, in particular, on works such as the construction of bridges and roads. Interestingly, he distinguished between those public works which were necessary either for the defence of the society or for the administration of justice, that is to say the first two categories on public functions, and the other works that were necessary, "chiefly those for facilitating the commerce of the society, and those for promoting the instruction of the people ([7]). He acknowledged that, as a matter of principle, these works could be, and sometimes were in fact, carried out by individuals. However, he observed that it was, as it still is, often difficult for them to obtain an adequate profit.

This empirical finding had important normative advantages. First, as realists have long maintained, it reflected a legal reality, that is to say that the role of the State was not limited to the regulation of market forces. It was, rather, during the

[6] A. Smith, *An Inqury into the Nature and Causes of the Wealth of Nations* (1789, 5th ed) (hereinafter *Wealth of Nations*), book IV, chapter IX.

[7] A. Smith, *Wealth of Nations*, cit. at 6, book V, chapter I, third part (Smith referred to the "erecting and maintaining those public institutions and those public works, which, though they may be in the highest degree advantageous to a *great society*, are, however, of such a nature, that the profit could never repay the expense to any individual or small group of individuals") (emphasis added). See, however, R. Musgrave, *The Theory of Public Finance* (1959), 563 (criticizing Smith on the questionable assumption that he considered only goods, neglecting services, notably those related to education)

Nineteenth century that *laissez-faire* theories took place. Second, Smith was interested in ascertaining the rationales underlying the role of the State as a builder, owner and manager of some essential infrastructures. Third, as Smith concluded, the money for funding such works could derive from taxation. It could also derive from borrowing, he added, provided that this did not generate an "enormous debt", in contrast with the safeguard of public trust in government bonds ([8]).

This is, of course, an oversimplification of Smith's thoughts about the State. However, it may at least give a glimpse of the theories that were regarded as "natural" not only by economist, but also by public lawyers at the end of the Nineteenth century ([9]). It may, in particular, shed some light on one issue. Although John Maynard Keynes observed that the rights of property and of free trade, as conceived during the eighteenth century, "accorded with the practical notions of conservatives and of lawyers" and that "a change [was] in the air" after the end of the *Belle époque* ([10]), the thoughts of public lawyers did not rest necessarily on the ideals of *laissez-faire*. They rested, rather, on the idea that the State – acting as a sovereign - has the power and the duty not only to lay down rules governing the market, in order to ensure its proper functioning, but also, in certain cases, to carry out economic activities.

According to Carl Schmitt's *Nomos der Erde*, there was a sort of compromise between the national sovereignty of the State, of each State, and the shared constitutional principles concerning the regulation of the economy. Schmitt argued that it was Maurice Hauriou, in his *Précis de droit public*, who masterly gave a theoretical basis to this institutional framework (11). He added

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[8] A. Smith, *Wealth of Nations*, cit. at 6, book V, chapter III.

[9] For a bird's eye view of the shift from the legal theories of the State prevailing in the nineteenth century to those of the twentieth, see J. Rivero, *Droit administratif* (1987, 12th ed.) 28 and M. Loughlin, *Public Law and Political Theory* (1992).

[10] See J.M. Keynes, *The End of Laissez-faire* (1926), in *Essays in Persuasion* (1931).

[11] C. Schmitt, *Das Nomos der Erde im Volkerrecht der Jus Publicum Europeum* (1950), translated by G.L. Ulmen, *The Nomos of the Earth in the International Law of Jus Publicum Europaeum* (2003), 140. In the burgeoning literature on Schmitt, an important study is R. Howse, *Europe and the New World Order: Lessons from Alexandre Kojeve's Engagement with Schmitt's 'Nomos der Erde'*, 19 Leiden Journal of International Law 93 (2006).

that the "common constitutional standard ... was more important than was the political sovereignty of the individual ... self-contained, and territorial continental states" ([12]).

This commonality was widely recognized by public lawyers at the end of the nineteenth century, with the notable exception of Albert Venn Dicey's overemphasis on the peculiarity of the English Constitution, and little point would be served by its repetition. The object of the present analysis is rather different. It is to observe that, for all the support given by public lawyers to *laissez faire* ideals, they did not believe that the (unwritten) economic constitution of their epoch excluded a more direct intervention by public authorities ([13]). Nor did they believe that government loans were unlawful. Rather, they thought that only extraordinary expenditure, such as those for infrastructures (railways, channels) could justify extraordinary revenues, such as loans ([14]).

B) Infrastructures and Deficits: Keynes and His Critics

Whether and the extent to that Keynes' critique to "classic" economists brought him to conceive a radically different theory it is an important question, but it is a question which falls beyond the limits of this article, and more generally beyond the limits of a legal analysis. The aim of this article is, rather, to argue that Keynesian economics undoubtedly gave much more importance to deficit spending although it did not necessarily implied the rejection of free market values ([15]).

[12] C. Schmitt, *The Nomos of the Earth*, cit. at 11, 211.

[13] See, in particular, S. Romano, *La libertà di commercio nei mercati municipali* (1925), in *Scritti minori* (Milan, Giuffrè, 1950), II, 275.

[14] See, among others, A. Wagner, *Three Extracts on Public Finance*, in R.A. Musgrave – A.T. Peacock, *Classics in the Theory of Public Finance* (1958), 7 (raising the question whether public expenditure "can be allowed to become so high that the requisite taxation becomes an oppressive burden to the people"); G. Ricca Salerno, *Scienza delle finanze* (1890, II ed.), 99-102. In more recent economic literature, see R.A. Musgrave, P.A. Musgrave, *Public Finance in Theory and Practice* (1989, V ed.), 553.

[15] J.M. Keynes, *The General Theory of Employment, Interest and Money* (1936), 379 (holding that "apart from the necessity of central controls to bring about an adjustment between the propensity to consume and the inducement to invest, there is no more reason to socialize economic life than there was before").

From the first point of view, which is of more direct interest for our purposes, Keynes pointed out the growing importance of the

"[i]nvestments entered upon by, or at the risk of, public authorities, which are frankly influenced in making the investment by a general presumption of there being prospective social advantages from the investment, whatever its commercial yield may prove to be within a wide range, and without seeking to be satisfied that the mathematical expectation of the yield is at least equal to the current rate of interest, — though the rate which the public authority has to pay may still play a decisive part in determining the scale of investment operations which it can afford" ([16]).

Keynes then went on to argue that, for all the importance of monetary policy, he was skeptical about its chances of success. He expected:

"[t]o see the State, which is in a position to calculate the marginal efficiency of capital-goods on long views and on the basis of the general social advantage, *taking an ever greater responsibility for directly organising investment*; since it seems likely that the fluctuations in the market estimation of the marginal efficiency of different types of capital, calculated on the principles I have described above, will be too great to be offset by any practicable changes in the rate of interest" ([17]).

In sum, Keynes argued that government expenditure was a key component of fiscal policy. Public authorities had, therefore, to use it as a policy instrument, in order to stimulate growth and, thus, ensure full employment. This did not mean, for sure, that any kind of measure is indifferent for government. Keynes referred to government investment in infrastructure. He argued that governments can, and should finance the funds for such investments by borrowing money through the issue of bonds, underlying assumption that the outcomes of investments, through taxation, sooner or later will repay the capital and the interests to be given to lenders. Even Keynes' criticized remark about paying

[16] J.M. Keynes, *The General Theory of Employment, Interest and Money*, cit. at 15, chapter 12, § 8.
[17] J.M. Keynes, *The General Theory of Employment, Interest and Money*, cit. at 15.

people to dig holes could be regarded as a metaphor for works in the public interest.

This line of reasoning is not, however, without problems. The first, and most obvious, problem is whether such public expenditure is really productive. This problem was highlighted not only by Friedrich von Hayek, but also by Lionel Robbins in a famous letter to "*The Times*" ([18]). According to them, a second problem with deficit spending is closely related to its impact on financial markets. They pointed out the need to safeguard the supply of capital to private industry. They objected, therefore, to the creation of "public debt on a large scale". Thirdly, they criticized Keynes (and Pigou) for affirming that "this is a time for new municipal swimming baths, etc., merely because people 'feel they want' such amenities". Hayek and Robbins held that there was no reason for central and local authorities to engage in such activities.

C) From Democracy in Deficit to the Deficit of Democracy

The fourth problem with relying on government deficits per se is rather different in nature from the three that have already been considered. It regards neither the economic sphere nor the conditions which must be met for governments to take a "*responsibility for directly organising investment*", to borrow again Keynes' words. Rather, it regards its political and constitutional implications. There is an extensive body of literature concerning the proper relationship between government revenues and expenditure. In particular, the Swedish economist Knut Wicksell argued that a problem which had "never received the attention it deserve[d]" was, on the one hand, how to ensure that a public expenditure "holds out any prospect at all of creating utility exceeding the cost" and, on the other hand, how to ensure the observance, in this respect, of the principle of voluntary consent to taxation ([19]). He added that, if loans are used instead of taxes, "there is a clear case for the requirement of full unanimity of all parties as the only possible guarantee against prejudicing their

[18] Letter to the Editor of the "The Times", October 17, 1932.

[19] K. Wicksell, *A New Principle of Just Taxation* (1896), in R.A. Musgrave – A.T. Peacock, *Classics in the Theory of Public Finance*, cit. at 14, 72, 89 and 91.

interests" ([20]). What Hayek and Robbins, as well as others, argued was coherent with this literature. They argued that:

"[m]any of the troubles of the world at the present time are due to imprudent borrowing and spending on the part of the public authorities. We do not desire to see a renewal of such practices. At best they and they tend to drive up the rate of interest".

What matters, for our purposes, is not the remark concerning the risk that interest rates are driven up, and thus have a negative impact on financial markets. What matters is, rather, the observation that growing and "imprudent" borrowing measures may "mortgage the Budgets of the future" ([21]). Importantly, this critique does not focus on the deviation from the traditional doctrine according to which government budget must be balanced or in surplus. It argues that, although governments have always requested and obtained loans from bankers, there are limits to the exercise of this kind of power. If such power is exercised unlimitedly, this can lead to a tension with a more fundamental value that liberal democracies must safeguard. If the machinery of government, so the argument goes, generates a high, increasing, and instable public debt, this will inevitably impinge on future governments' capacity to deal with the debt and to be responsive to their citizens' future demands.

In this line of reasoning there are two related, but distinct, normative arguments. First, as observed earlier, there is a normative argument based on the ideals of a limited government. More precisely, constitutions serve to ensure that those who govern us take decisions in a manner that makes their costs and benefits as clear as possible and are thus accountable. Deficit spending, instead, tends to generate "fiscal illusions", that is to say to hide more or less significant parts of the costs. In this sense, deficit spending is regarded as jeopardizing the proper functioning of representative institutions ([22]). This normative argument has a moral component, though not explicit, that is to

[20] K. Wicksell, *A New Principle of Just Taxation*, cit. at 19, 106 (explicitly referring to Wagner's analysis, quoted earlier).

[21] Letter to the Editor of the "The Times", October 17, 1932.

[22] G. Sartori, *Democrazia. Cosa è* (1994), 315. See also J.E. Buchanan – R. Wagner, *Democracy in Deficit. The Political Legacy of Lord Keynes* (1978) (for the thesis that the changes in US budgetary policies were based on Keynes' theories).

say, the need to protect democracy, seen as the worst of all possible forms of government, except the others, to borrow Winston Churchill's well known aphorism.

The moral component is even stronger in the second normative argument. A political system that extensively and increasingly relies on deficit spending, especially if public expenditure funds consumption as opposed to infrastructures, cannot achieve the goal of generating an economic growth that, within a certain period of time, repays capital and interest. It would be obviously difficult to determine empirically what is the limit that should not be crossed. However, there is evidence that the more public expenditure is funded by borrowing money for purposes of consumption, the more it has only distributive effects, instead of increasing the general wealth. In other words, it tends to favor particular groups, if not individuals ([23]). The question that thus arises, which is a moral question, as observed by John Rawls, probably the most influential political philosopher of the last fifty years, is what justifies the choice to ensure some benefits to those particular groups and individuals today, at the expenses of other groups and individuals in the future, that is to say of another generation, which receives little or no benefit from deficit spending ([24]). In both these respects, excessive government deficits, or a democracy in deficit, may transcend into a deficit of democracy.

3. Constitutional Limits on Government Deficits: A Comparative Analysis

There is little doubt that the development of new economic theories gradually influenced the law. New interpretations of existing constitutions were elaborated, discussed, and enforced. New constitutional provisions were introduced, in order to achieve social justice. Much has been written on the way in which the concept of Welfare State has spread throughout Western

[23] For an analysis from the point of view of political science, see J. White – A. Wildavsky, *The Deficit and the Public Interest. The Search for Responsible Budgeting in the 1980s* (1989).

[24] J. Rawls, *A Theory of Justice* (1971), § 44 (for an analysis of justice between generations).

Europe since its inception. While this literature contains many useful insights, it will be argued that two central aspects of the topic have been insufficiently examined and only rarely adequately understood.

The first of the issues which will be considered concerns the rationales for the introduction of constitutional limits to the discretionary powers enjoyed by parliaments. Legal systems have two or three principal mechanisms through which such discretionary powers can be limited and structured, in order to ensure accountability to the public. Notwithstanding the differences, which are not only of detail, it is common for constitutions to exclude that parliaments may decide about public expenditure without the consent of the executive.

The second of the issues which will be examined concerns, more specifically, the constitutional limits concerning the expansion of government deficit or debt. It is well known that this expansion has taken place for a variety of economic and political reasons and little point would be served by its repetition. The object of the present analysis is rather different. It is to consider whether, whatever the differences concerning the form of State and the structure of government, there are at least some shared understandings about the need to limit the expansion of debt and deficit.

A) Public Expenditure and the Limits to the Will of the Majority

When considering public expenditure, the 'standard' remark is that not only its size but also its composition varies form one State to another and that such variables depend on history and culture, as well as on ethical criteria concerning the role of individual and social groups within a given State. In a general sense this is true, but this explanation does not give a full representation of a more complex reality. It neglects some aspects that could suggest a more nuanced and perhaps interesting story. It can be argued that, for all the importance of parliaments' role as 'theatres' of differentiated societies and more specifically as budgetary authorities ([25]), European constitutions set limits to the

[25] Without parliamentary consent, government budgets cannot be approved and ministries and agencies cannot spend outside a provisional and limited part of the preceding year's budget. For a comparative analysis, see D. Coombes

will of parliamentary majorities with regard to the increase of public expenditure.

The unwritten or "historic" constitution of the United Kingdom has a special relevance in this respect, because for a long period of time it has been considered by academics and politicians as a sort of model. The members of the House of Commons do not have the right to propose money bills, which are reserved to the executive branch of government. The underlying reason is still that which was indicated by Walter Bagehot soon after the fundamental electoral reforms of the Nineteenth century. The House was not anymore a guardian of the treasury, in order to limit taxation. It was, rather, more interested in spending ([26]).

Whatever the institutional and political distinctive traits between democracy in the UK and Germany, the latter is not based on a radically different philosophy. The mechanism governing the functioning of political decision-making processes is to be found in Article 113 (1) of the *Grundgesetz* (1949) ([27]). Under Article 113 (1), it is for Parliament to approve spending bills. However, it allows Parliament to do so only if the executive approves the acts that increase the expenditure proposed in the federal budget or that imply new expenditure or, finally, that imply them for the future. Interestingly, the Spanish Constitution (1978) follows the same logic. It requires that every proposal or amendment that may alter the balance established by the budget must be accepted by the executive (Article 134 (6)). The French Constitution (1958) probably goes one step further. It lays down a prohibition to accept the proposals and amendments formulated by the members or Parliament if their adoption implies either a reduction of public revenues or the increase of expenditure (Article 40) ([28]). Only apparently does the Italian Constitution

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(ed.), *The Power of the Purse. The Role of European Parliaments in Budgetary Decisions* (1976).

[26] W. Bagehot, *The English Constitution* (1867), chapter IV ("The House of Commons … has long ceased to be the checking, sparing economical body it once was").

[27] See A. Zunker, *Consequences of the Federal System for the Parliamentary Control of the Budget in the Federal republic of Germany*, in D. Coombes (ed.), *The Power of the Purse. The Role of European Parliaments in Budgetary Decisions*, cit. at 25, 46.

[28] For further remarks, see P. Lalumiere, *Parliamentary Control of the Budget in France*, in D. Coombes (ed.), *The Power of the Purse. The Role of European Parliaments in Budgetary Decisions*, cit. at 25, 128, 133.

(1948) lay down the same principle. Indeed, following the Wicksellian theory, it allows Parliament to increase public expenditure or to introduce new programmes only if the corresponding revenues are indicated (Article 81). However, the related goal to protect the role of the executive has only partially been achieved ([29]). Only many years later, in 1988, have some limits been introduced by ordinary legislation, which – by virtue of the principle *lex posterior derogat legi priori* - can be modified by any subsequent act of Parliament.

In sum, the solutions envisaged by national constitutions to prevent an uncontrolled growth of public expenditure vary between an extreme, the absence of a parliamentary initiative concerning money bills, to another, the simple need to indicate the corresponding public revenues. Moreover, the effectiveness of these limits depends on a variety of institutional and political factors, including the willingness of assemblies' presidents, auditing bodies, and the courts to enforce them. Only some constitutions, such as that of Germany, allow individuals to bring actions before constitutional courts. However, it can be said that the issue indicated by less and more recent economic theory, that is to say the need to ensure that a proper relationship is kept between expenditure and revenues, is not neglected by the constitutions of Europe. In this sense, and within these limits, it can be said that there is a common constitutional tradition ([30]).

B) Limits to Government Deficits and Debts

It was pointed out earlier that the division of powers between the legislative and executive branch of government is not the only way through which modern European constitutions seek to limit the expansion of public debt and deficit. It will be argued now that other limits derive from a variety of constitutional norms that fulfil different functions. Furthermore it will be argued that the development of such limits has not only preceded, but also

[29] See V. Onida, *The Historical and Constitutional Foundations of the Budgetary System in Italy*, in D. Coombes (ed.), *The Power of the Purse. The Role of European Parliaments in Budgetary Decisions*, cit. at 25, 215 and his fundamental and ponderous monograph *Le leggi di spesa nella Costituzione* (1969).

[30] For this thesis, see G. della Cananea, *Lex Fiscalis Europea*, in *Quaderni costituzionali* 15 (2014), forthcoming.

followed the achievement of the EMU and the more recent steps taken by the vast majority of its members.

The first function that is performed by this second group of constitutional norms is a variation on the theme just explored, that is to say the maintenance of a proper relationship between expenditure and revenues. As Wicksell put it, "no public expenditure [should] ever be voted upon without simultaneous determination of the means of covering their cost" ([31]). This implies prescribing the antecedence of revenues with respect to expenditure. Parliamentary majorities cannot, therefore, choose revenues only after determining a certain level of public expenditure ([32]). Article 34 of the French Constitution is particularly explicit in this respect, while similar mechanisms are established elsewhere either by legislation or by parliamentary rules.

The second function that is performed by constitutional norms is a limiting function. Sometimes, this limiting function is expressed in very broad terms, such as the duty to take the overall economic balance into due account (Article 109 of the *Grundgesetz*; Article 13 of the Austrian Constitution). Sometimes, this limiting function is performed more precisely, as it happened in the recent revision of the German *Grundgesetz* ([33]).

A third function that is performed by constitutional norms is at the same time a limiting function and one of incentive. Consider, for example, Article 119 (6) of the Italian Constitution. It establishes that "Municipalities, Provinces, Metropolitan Cities and Regions (…) may resort to indebtedness only as a means of financing investment expenditure. State guarantees on loans contracted for this purpose are not permitted". While the first rule is a variant of the golden rule, according to which local authorities can only (here lies the limitation) contract loans, and thus produce

[31] K. Wicksell, *A New Principle of Just Taxation*, cit. at 19, 91.

[32] See F.A. von Hayek, *Law, Legislation and Liberty*, I, *Rules and Order* (1973), Chapter 6 (arguing that the contrary practice runs against the fundamental principles of a just government).

[33] For further details, see L.P. Feld – T. Daskaran, *Federalism, Budget Defict and Public Debt: on the Reform of Germany's Fiscal Constitution*, 6 Review of L. & Econ, 365 (2010). For a comparison with the US, see R. Kiewet – K. Szakaly, *Constitutional Limitations on Borrowing: an Analysis of State Bonded Indebtness*, 12 J. Law, Econ & Org. 62 (1996).

debt, for funding investment (here lies the incentive), the other excludes any State guarantee on such loans. Considered as a whole, both rules aim at avoiding moral hazard and safeguarding financial stability.

C) Financial Stability: A Common Constitutional Tradition?

At this stage, some words are required in order to prevent any possible misunderstanding of the argument adumbrated above. Such argument is neither that the liberal democracies of Europe public authorities are placed under the same rules nor that their budgetary policies are largely the same. Indeed, there are important differences concerning the size of public expenditure, its distribution between the various public policies, and the respective weight of the various kinds of revenues. Such differences reflect national traditions, political preferences and, ultimately, moral choices about the role of individuals and social groups.

The foregoing discussion is intended, rather, to lay the proper foundations for an adequate understanding of the principles and rules of law in the context of the EU. The Union's principles and rules of law have not emerged *ex nihilo*. The EU is not simply to be viewed as a compact between States, as an area of economic integration that could be established by nations situated in every corner of the world. Quite the contrary, it is a community based on a set of common values. Such values include not only democracy and the rule of law, liberty and fundamental rights, but also at least a broad concept of stability of public finances. It is in this sense and within these limits that it can be said that a common constitutional tradition has emerged, imposing political institutions not to conduct their budgetary policies in ways which jeopardise financial stability in the medium run.

Precisely because common constitutional traditions are general principles of Community law ([34]), as opposed to detailed

[34] It is an established doctrine of the ECJ, codified by Article 6 TEU, that common constitutional traditions have the status of general principles of Community law. See G. Pizzorusso, *Il patrimonio costituzionale europeo* (2002). See also K. Tuori, *The European Financial Crisis – Constitutional Aspects and Implications*, EUI working paper n. 2012/28 (pointing out the interaction between the Constitution of the EU and those of its Member States).

rules, they leave wide margins of manoeuvre to national policy-makers. However, their impact must not be neglected. As the European Court of Justice argued in *Van Gend en Loos*, the Member States have agreed to mutually limit their sovereign rights ([35]). Accordingly, their constitutional rules concerning the determination and conduct of budgetary policies must be interpreted coherently with the engagements stemming from both the European treaties and the acts issued by the institutions of the EU. The commonalities that already existed before such treaties and acts came into being, therefore, are strengthened by them.

4. Government Deficits in the Economic and Monetary Union

Before considering how the shared value of financial stability is reflected in the law of the EU, it is useful to clarify that such law applies differently within the EMU, also in the light of the recent Stability, Coordination and Governance Treaty of 2011, known as the Fiscal Compact. Next, two aspects will be considered. They are of particular interest, not only for their inherent importance as far as government deficits are considered, but also because of the more general light that they cast on EMU. The first of the aspects that will be considered concerns the rationale for distinguishing the expenditure for government investments from other parts of public expenditure. The second of the issues that will be examined concerns the effects of the rule enshrined into the Treaty. It will be argued that, whatever the conventional nature of the distinction between government expenditure for consumption and investment, the latter has a specific legal status.

A) EMU and Differentiated Integration

Descriptively, it can be said that: i) all the Member States of the EU have agreed to create the EMU, in addition to the Single Market, as instruments for achieving the "ever closer union between European peoples" provided by the preamble to the Treaty of Rome, and; ii) all of them, consequently, are subject to

[35] ECJ, Case 26/62, *Van Gend en Loos v Nederlandse Administratie der Belastingen* (1963).

the "guiding principles" that govern the actions of the EU and of its Member States, but iii) only some of them have decided to renounce to their national currency, in favour of the euro, after satisfying the conditions and limits established by the Treaties.

The EU is, therefore, much more fragmented than it is usually believed. The usual metaphor of the concentric circles can be used to convey the sense of this differentiation. Alternatively, to borrow the metaphor of the club ([36]), it can be said that the Union does not prevent its members from creating more integrated clubs, such as that of the countries whose currency is the euro ([37]). However, from a legal point of view, it is more correct to say that within the EU membership, which is the first and main element of a legal order ([38]), is differentiated. Nothing prevents the establishment of areas of closer or enhanced cooperation ([39]). Other forms of closer integration, moreover, can be established between the countries whose currency is the euro and the others. This is precisely the case of the recent form of cooperation established by the Stability, Coordination and Governance Treaty of 2011 between the Member States whose currency is the euro and some of the others, which do not adopt the euro ([40]). Although only England and the Czech Republic decided not to sign the new Treaty ([41]), formally this leaves it outside the area of EU law. As a consequence, the Fiscal Compact does not enjoy, under national constitutions, the legal status which

[36] For this metaphor, see R.O. Keohane – J.S. Nye, *Between Centralization and Fragmentation: the Club Model of Multilateral Cooperation and Problems of Democratic Legitimacy*, in R.B. Porter *et al* (eds.), *Efficiency, Equity, and Legitimacy: The Multilateral Trading System at the Millennium* (2001), 286.

[37] See F.G. Snyder, *EMU - integration and differentiation: metaphor for European Union*, in P. Craig – G. de Búrca (eds.) *The Evolution of EU Law* (2011), 687.

[38] For this thesis, see S. Romano, *L'ordinamento giuridico* (1946, 2nd ed.).

[39] The preamble of the Fiscal Compact explicitly notes "the wish of the Contracting Parties to make a more active use of enhanced cooperation".

[40] This differentiation is recognized and emphasized by Article 1 (2) of the Fiscal Compact, according to which "[T]his Treaty shall apply in full to the Contracting Parties whose currency is the euro. It shall also apply to the other Contracting Parties to the extent and under the conditions set out in Article 14". The last recital of the Preamble refers specifically to such countries.

[41] See P. Craig, *The Stability, Coordination and Governance Treaty: Principle, Politics and Pragmatism*, 37 Eur. L. Rev. 231 (2012) (discussing the reasons for British refusal to sign the Treaty).

is recognized to EU law, but, more generally, that of international agreements

The picture which emerges is an interesting one. The new Treaty is genetically and intrinsically distinct from the treaties upon which the EU is founded and cannot alter the obligations deriving from them, but it specifies such obligations and strengthens them. There is, moreover, a sort of "*norme passerelle*". The distinction between the Fiscal Compact and the EU treaties, therefore, does not exclude a correlation.

B) The Guiding Principle of Financial Stability

With regard to the treaties, Articles 119 and 126 TFEU combine to lay down the fundamental principles of EU law concerning public finances.

Article 119 is the Treaty (TFEU) provision that governs the economic policies of the EU and of its Member States. It is the provision that, in the past, has attained by far the highest profile in this area of EU law and the fiercest criticism, because it sets the four "guiding principles". Such principles include stable prices, sound public finances and monetary conditions and, finally, a sustainable balance of payments. The increasing political opposition to those that were perceived as the guiding principles of neo-liberal economic constitution, in conjunction with free competition, probably explains why the drafters of the Lisbon Treaty decided to move this provision from Article 4 of the Treaty establishing the European Community, to the sector-specific provisions concerning the EMU.

Whether its intrinsic importance has decreased, however, is questionable. On a formal level, what matters is that the other provisions of the TFEU still refer to Article 119, as a source of guiding principles. In particular, when dealing with the economic policies of both the Union and its Member States, Article 120 refers to the objectives of the Union and to "the principles set out in Article 119". On a substantive level, the persisting high profile of Article 119 is demonstrated by the fact that the institutions of the EU constantly refer to those principles, in particular to sound public finances and monetary conditions.

It is important to stress, again, that the limits introduced by the EU do not depend on a specific view about the level of public expenditure. They depend, rather, on the more general preoccupation to prevent any *moral hazard* ([42]), which may jeopardise economic integration ([43]). Provided that the principle of financial stability is respected, in the logic of subsidiarity national budgetary policies can and do differ in many other respects.

C) The Prohibition of Excessive Government Deficits

Article 126 TFEU implements the "guiding principle" according to which public finances must be sound, by laying down a more specific principle. Its text is quite concise – "Member States shall avoid excessive government deficits". Its content is clarified by the specific Protocol, which defines the concept of deficit and that of "government", by combining the subjective criterion (the State, regions and local authorities) and the objective criterion (the funds concerning social security).

Leaving aside for a moment what is meant by "excessive", the effects of the provision regulating national deficits can be appreciated from a twofold point of view. First, the word "shall" does not leave any doubt as to whether the provision has binding effects. This is confirmed by the provision concerning the UK, according to which it must simply "endeavour" to avoid excessive government deficits. In other words, the special rule concerning the UK, which merely establishes a duty of conduct, clarifies the content and effects of the general rule, which instead establishes an effect-based prohibition, and by all means a broad provision. Second, the derogation from the infringement procedures set by the Treaty does not mean that the respect of such rule is simply left to the good will of the States. Indeed, a specific procedure is provided. It introduces a "multilateral surveillance", which is in the hands of the Commission and the Council. In short, it is the Commission that proposes and the Council that decides whether a Member State has an excessive government deficit.

Several academics and politicians have stressed the negative nature of the norm – a prohibition – and the fact that it is

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[42] J. von Hagen, I. Harden, *National Budget Processes and Fiscal Performance*, in *European Economy Reports and Studies*, 1994, 311, 339.

[43] For further remarks, see I. Harden, *The Constitutional Framework of the Euro: the Fiscal Constitution of EMU*, in P. Beaumont – N. Walker, *Legal Framework of the Euro* (1999), 78 (arguing that the EMU has a "post-Keynesian constitution").

unconditional, with the intent of affirming that such norm should be regarded as a rule, not as a principle. However, whatever the intellectual soundness and political desirability of a sort of automatic mechanism of enforcement, neither the Treaty nor institutional practice sustain this interpretation. To begin with, the institutions of the EU possess the minimum of interpretative leeway that is inherent in any system of legal norms. Even a quick look at the Treaty shows that, for all the importance of the quantitative standards referred to therein, such standards do not have the effects of precluding to a Member State the access to the third stage of EMU ([44]). Legally, it is not without significance that neither the 60% ratio between the debt and gross national product nor the 3% ratio between the deficit and the GNP is established by the Treaty itself, but by the specific Protocol, which can be amended more easily. It is still more significant that those quantitative standards must be weighed with other standards, of qualitative nature. To the extent that these standards include for example the substantial decline of the ratio between the deficit and the GNP or the level of the debt approaches "the reference value at a satisfactory pace" ([45]), it can be argued that they serve precisely to leave a sufficient leeway to the institutions of the EU ([46]), particularly to the Council. Institutional practice confirms this interpretation, even though the Court of Justice has punctually held that the discretionary powers enjoyed by the Council regard the merit of its decisions, not the procedure for assessing whether a deficit exists. The whole procedure cannot, therefore, be put in abeyance ([47]).

[44] See W. Buitler, G. Corsini, and N. Roubini, *Excessive Deficits: Sense and Nonsense in the Treaty of Maastricht*, *Economic Policy*, 1993, 60.
[45] Article 126 (2) (a) and (b) TFEU.
[46] See P. De Grauwe, *The Economics of Monetary Integration* (1994, 2nd ed.), 202 (observing that "whereas the Delors Committe considered these rules to be binding, the drafters of the Maastricht Treaty abandonded the idea of strictly binding rules").
[47] See ECJ, Case C-27/04, *Commission v. Council* (2004). For further remarks, see R. Perez, *Corte di giustizia e regole fiscali dell'Unione*, 10 *Giorn. dir. amm.*, 1073 (2004).

D) The Pro-Investment Choice and Its Rationales

Within this procedure, if a Member State does not fulfil the requirements under one of those criteria, the Commission shall prepare a report and such report shall refer to a variety of "relevant factors". The first of such factors is "whether the government deficit exceeds government investment expenditure", as provided by Article 125 (3). The rationale for this norm will be considered more fully below. For the present, it is worthwhile reflecting a little on some aspects.

First, government investment expenditure is a key element in the Commission's assessment of national budgetary performance. While the Treaty refers generically and vaguely to the "relevant factors which the Commission must take into account, government investments are specifically referred to, unlike "all other relevant factors", except the medium-term position of the budget.

Second, whatever the intellectual soundness and practical operability of the distinction between the two components of government expenditure, consumption and investments, such distinction is not only legally relevant, but it produces very important effects. When the Commission assesses national deficits, it has the duty (expressed by the word "shall") to take into account the component of government expenditure that is related to investments. The Commission's role is, therefore, to operate not only to assess "whether the government deficit exceeds government investment expenditure", but also to ensure that the public finances of each Member State fulfil the guiding principle of financial stability ([48]).

Thirdly, the rule laid down by Article 126 (3) is not a mandatory rule, that is to say one that requires the States to spend public money for investments. It is, rather, a rule that discriminates between government expenditure for consumption and investment, in order to encourage or incentive the latter. Another way, probably more precise, of putting the same point is that the Treaty lays down a sort of golden rule that encourages the

[48] O.J. Blanchard - F. Giavazzi, *Improving the SGP Through a Proper Accounting of Public Investment*, CEPR Discussion Paper No. 4220.

Member States to have recourse to borrowing only for funding investments. It is, therefore, a pro-investment choice ([49]).

Its underlying reasons can be explained as follows. Legal systems have two principal mechanisms through which to protect and promote those public works that Adam Smith regarded as necessary "for facilitating the commerce of the society, and (…) for promoting the instruction of the people". They may, first, introduce legal norms that work as incentives. To rely solely on this kind of instrument can, however, be inefficacious. For this reason, during the twentieth century new economic theories – inspired by Keynes - have emphasized the more direct involvement of governments in the financing of investments, particularly in infrastructures.

Of course, the functions of the EU in this respect cannot be the same as those of the States. The main differences are the limited competence of the Union, in the logic of subsidiarity, as well as its limited financial capacity. Notwithstanding these differences, which are not of detail, the EU can "contribute to the development of trans-European networks in the areas of transport, telecommunications and energy infrastructures" ([50]), that is to say the main services for modern industrial democracies. It may in particular "support project of common interests supported by Member States" through loan guarantees or interests-rate subsidies to the financing of specific projects in the area of transport infrastructure ([51]). For all the significance that such support may have in the perspective of providing European 'public goods', it is a support limited both in scope and financial dimension. Much ought to be done by encouraging private actions brought by business holding infrastructure networks or providing public utilities. Much can be done also by encouraging national policy-makers to invest money in public works.

The main mechanism for encouraging government investment expenditure contained in the Treaty is to be found in Article 126 (3). Under such norm any responsibility for choosing a

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[49] For the contrary opinion, see F. Balassone – D. Franco, *Public Investment, the Stability Pact and the 'Golden Rule'*, 21 *Fiscal Studies* 207, 226 (2000) (alleging that the rules set out in the Treaty and the SGP may negatively influence public investment).

[50] Article 170 (1) TFEU.

[51] Article 171 (2), third indent, TFEU.

certain level of public expenditure and its composition is reserved to national policy-makers, coherently with the principle of subsidiarity. What the Treaty does, rather, is to incentive them to use borrowing solely for investment expenditure. The underlying rationale is that only government investments are generally regarded as being capable of promoting and sustaining economic growth. Government expenditure for consumption has, instead, merely redistributive effects. Seen from this point of view, the distinction laid down by the Treaty reflects the preoccupation for any unjustified increase of government loans, although it does not exclude the possibility that investments are used for the purposes of fiscal policy.

At this point, it is useful to clarify that the observations made thus far aim at providing an interpretation of the legal provisions of the EU concerning government investment expenditure. Their aim is not to consider critically neither the EU standards concerning government deficits nor the actions carried out by the institutions of the EU, particularly in the context of the economic and financial crisis ([52]). Whether there are deficiencies in those standards, as well as in the institutions' manner of enforcing the Treaty is an important issue, but it is another one.

For our purposes, what matters is to provide a reasonable interpretation of the Treaty. It is also interesting to add that neither the various versions of the Stability and Growth Pact (SGP) ([53]), nor the Fiscal Compact have attenuated the importance attached to government investments. When the Commission made the proposal for the first revision of the SGP, in 2004, it explicitly referred to government investments and the Council accepted such proposal ([54]). More recently, Regulation n. 1175/2011, which has confirmed the balanced-budget rule (imposing that the budgets of the contracting parties must be either balanced or in surplus), has reiterated the need that the States provide information concerning the main economic variables that are relevant for the achievement of the stability program, including

[52] See M. Ruffert, *The European Debt Crisis and European Union Law*, 48 Common Market L. Rev., 1777, 1786 (2011) (criticizing the measures taken by the EU to deal with the debt crisis, precisely because they endanger financial stability).
[53] For further details and remarks, see J.V. Louis, *The Review of the Stability and Growth Pact*, 43 Common Market L. Rev. 85, 94 (2006).
[54] Regulation n. 1055/2005 (amending Regulation n. 1466/97), Article 2-*bis*.

government investments [55]. This serves to permit the States to have a margin of manoeuvre, especially in view of the need of public investments [56]. The Fiscal Compact has not introduced any change in this legal framework. This limitation is explicitly acknowledged by Article 2 (1) of the Fiscal Compact, according to which the Treaty "shall be applied and interpreted by the Contracting Parties in conformity with the Treaties on which the European Union is founded". This is confirmed by the following paragraph, which provides that the Treaty "[s]hall apply insofar as it is compatible with the Treaties on which the European Union is founded and with European Law". In conclusion, the choice made by the constitutional provision, Article 126 (3), has been confirmed by the subsequent norms and agreements.

E) External Constraints on National Constitutions?

A final question must be considered. It is the question whether the mechanism established by the Treaty and left unchanged by the Fiscal Compact produces undue external constraints on national constitutions. This question should be considered on both formal and substantive grounds.

Formally, neither the Treaty of Maastricht nor the Fiscal Compact required the Member States to amend their constitutions. Rather, the former required them to take the necessary steps in order to ensure that the obligations stemming from the Treaty could be fulfilled [57] and the latter does not impose any constitutional change. In particular, the "heart" of the Fiscal Compact [58], that is to say the "balanced budget" rule and the obligation to introduce automatic corrective mechanisms, requires the contracting parties to adopt norms of permanent and binding nature, "preferably constitutional". Furthermore, it explicitly adds

[55] See Article 3 (*b*), of Regulation n. 1466/97, as recently amended. See also the Commission's Communication *A blueprint for a deep and genuine economic and monetary union. Launching a European debate*, COM(2012) 777 final/2.
[56] See the seventeenth indent preceding the text of the Regulation n. 1466/97.
[57] Article 3, Protocol on excessive government deficits.
[58] P. Craig, *The Stability, Coordination and Governance Treaty*, cit. at 41, 234.

that the corrective mechanism must "respect the prerogatives of national Parliaments" ([59]).

On more substantive grounds, it may be argued that any mechanism of conditional incentive, such as that contained in the Treaty, inevitably influences the conduct of those who are subject to it. But this is an argument that proves too much, first, because this is not a mechanism of conditional funding, but of regulation, which is justified by a shared value, that of financial stability, and, second, because it largely corresponds to the 'golden rules' enacted by several legal orders, as observed earlier ([60]).

There are, therefore, no legal grounds for affirming that the EU treaties and the Fiscal Compact have limited national governments' capacity to promote investments, though from an economic perspective it can be argued that the latter should be amended ([61]). It is political economy or political science that may explain why in some countries, taxes have been cut in order to attract new investments, while elsewhere the high level of the debt accumulated in the past precludes any cut, or even requires higher or new taxes. It would be interesting also to understand why in some countries new financial resources are distributed not only to infrastructures, but also to education and research, while elsewhere pension schemes absorb an increasing portion of public budgets.

5. Conclusion

No attempt will be made to summarize the entirety of the preceding analysis. Nor will any attempt made to set out at least the main lines of a legal theory of government investments. This would require an extensive analysis in its own right, and not just one or few paragraphs at the end of an article that focuses, rather, on the limits laid down by legal orders, those of the EU and its Member States, on government borrowing. Only a brief word is, probably, useful in order to clarify the main aspects of the

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[59] Article 3 (2) of the Fiscal Compact. See, however, F. Fabbrini, *The Fiscal Compact, the "Golden Rule" and the Paradox of European Federalism*, 36 Boston College Int'l & Comp. L.Rev. 1, 25 (2013) (arguing that the new legal regime is less respectful of state sovereignty than that of the US).
[60] Supra, § 3 B).
[61] See R. Masera, *Eurobond per le infrastrutture*, *La Repubblica*, April 16, 2012, 10.

argument presented above. National budgets differ in many respects, because their reflect distinct traditions, as well as divergent political preferences with regard to the size and composition of public expenditure. However, the powers of budgetary authorities are not unlimited. Quite the contrary, they are limited by written and unwritten constitutional norms in several manners. Such limits reflect a shared value, that of financial stability. It is not fortuitous, therefore, that the Treaty refers to such value, including it among the guiding principles of EU and national policies. It is this value that justifies the pro-investment choice, on the underlying assumption that government investment expenditure can have a positive impact on growth, whilst ensuring that financial conditions are sound. It remains to be seen, of course, whether such assumption is realistic and this depends more on the actions of national policy-makers than on those of the EU, which can allow, incentive, and sustain their choices, but not replace them.