The Court of Justice and the Perils of Eurozone Fiscal Framework

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1. Introduction

The introduction of new instruments of regulation of economic policies in the Eurozone as a reaction to the financial crisis signed a severe constitutional challenge for the European Union.¹ The creation
of assistance mechanisms (EFSM, \(^2\) EFSF \(^3\) and ESM \(^4\)), the programmes of intervention of the ECB (particularly the OMT \(^5\)) and the way these instruments operated, created the room for several judicial challenges. Particularly Pringle\(^6\) and Gauweiler\(^7\) deal, mainly, Implicaciones Constitucionales de la Crisis: una Reseña de la Literatura Reciente, in Estudios de Deusto, vol. 64/1, 2016), p. 26-30.


\(^3\) European Financial Stability Facility, created as a company of Luxembourg law, after a decision of the Ecofin Council on 9 May 2012.

\(^4\) Treaty establishing the European Stability Mechanism, 2 February 2012.

\(^5\) Outright Monetary Transactions, as announced in Technical features of Outright Monetary Transactions, ECB Press Release, 6 September 2012.

\(^6\) Case C-370/12, Thomas Pringle v Government of Ireland, Ireland and The Attorney General [2012].


Other studies are particularly interested in the consequences for relationships between the national courts and the Court of Justice, and more generally, between the national and supranational orders, see T. Tridimas and N. Xanthoulis, A Legal Analysis of the Gauweiler Case. Between Monetary Policy and Constitutional Conflict, in Maastricht Journal of European and Comparative Law, vol. 23, 2016, p. 35 focused on the relationships between the CJEU and the national courts amidst Gauweiler. Before the judgement of the CJEU, for an analysis of the ultra vires action referred by the GFCC, see M. Wendel, Exceeding Judicial Competence in the Name of

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with a competence issue, which is connected to different interpretative approaches to EU law. Moreover, this issue mainly takes the form of the existence of the ‘authority’ to create ESM and OMT, challenged in those cases. The national courts have stressed the EU order to evaluate the balance between state and supranational powers. In particular, the Federal Constitutional Court of Germany (GFCC) proposed a vision of the Economic and Monetary Union based on a traditional view of the Treaties. The Court of Justice had to interpret the instruments using a teleological approach, i.e., to define the competences by looking at the objectives. This is particularly problematic in the paragraphs in which the Court of Justice faces the challenges to Articles 125 and 123.1 of the Treaty on the Functioning of the European Union. The Court was quite assertive in detecting several features of the instruments that assure compliance with the ultimate objectives of those provisions. This was one of the major critiques of Gauweiler by the GFCC in the judgement ending the OMT saga.

The goal of this paper is to stress the interactions between political theory and judicial reasoning emerging in the Court of Justice’s decisions about ESM and OMT. The interest in such an analysis is testified by the reflections on these interactions both in the Ledra case and in the judgement of the German Federal


8 S. Dahan, O. Fuchs and M. Layus, Whatever it Takes? Regarding the OMT Ruling of the German Federal Constitutional Court, in Journal of International Economic Law, vol. 18, 2015, p. 137. Faraguna, in a similar way, noted that the conflicts are determined by the way in which the economy became law and it affects the division of powers and competences in the Eurozone, see P. Faraguna, La saga OMT: il diritto all’ultima parola tra Corte di Giustizia e tribunali costituzionali, in Giurisprudenza Costituzionale, vol. 1, 2017, p. 568-569.

9 Joined Cases C-8/15 to C-10/15 P Ledra Advertising Ltd and Others v European Commission and European Central Bank (ECB) [2016]; see also Joined
Constitutional Court concluding the Gauweiler saga. This research aims at using political theory to understand what the Court of Justice seems to be doing when it evaluates the compatibility of the instruments to the Treaties. The Court has only partially expressed in its reasoning the background of this new – at least for some aspects – approach to the EMU’s economic constitution; this has contributed to the definition of the conclusions of these judgements as problematic.

To better understand the reasoning, it may be worthwhile to consider a general perspective to answer the following questions: How the cases of the CJEU could be read according to the perspective of the fiscal federalism theory? Which are the plausible implications of this approach on legal grounds?

One of the objectives of this analysis is to offer a different perspective to the debate about the use of textual and teleological interpretations by the Court of Justice that started after the Pringle case. While all the authors have admitted the existence of this plurality of interpretative approaches, they have mainly disputed the evaluation of it; G. Beck particularly criticised the Court of Justice,

Cases C-105/15 P to C-109/15 P Konstantinos Mallis and Others v European Commission and European Central Bank (ECB) [2016].

10 2 BvR 2728/13, 21 June 2016. For the central role of the legal reasoning in helping to understand the main features of EU law, see J. Bengoetzea, The Legal Reasoning of the European Court of Justice: Towards a European Jurisprudence, Oxford University Press, 1993.

11 Also, P. Craig, Pringle: Legal Reasoning, Text, Purpose and Teleology, in Maastricht Journal of European and Comparative Law, vol. 20, 2013, p. 3 ss, considered the way in which the conclusions were drawn in Pringle to be highly problematic, particularly the interpretation of Article 125.


because in adopting a teleological approach, it crossed the line between legal reasoning and political judgement.\textsuperscript{14} P. Craig’s analysis instead aimed at diminishing the concern about the Court’s interpretative approach, clarifying that there is always a combination of textual argumentation and the underlying teleological assumptions or objectives in judicial reasoning.\textsuperscript{15} The Court decides to pay more attention to the teleological aspect when a textual analysis is not sufficient to legitimise the desired conclusion.\textsuperscript{16} This particularly occurred in Pringle: The Court of Justice, to save the ESM, had to adopt a teleological approach to treaties, and particularly, to the no-bailout provisions.\textsuperscript{17} The main outcome of this teleological approach was the emergence of a new principle underlying the economic constitution of the Economic and Monetary Union, i.e., the stability of the Eurozone as a whole.\textsuperscript{18} The same dichotomy is evident in the Court’s reasoning in Gauweiler, particularly in the interpretation of Article 123.1 of the Treaty on the Functioning of the European Union. Particularly, the GFCC and the Court of Justice used the Pringle precedent in different ways, evaluating the objectives of

\textsuperscript{14} This author particularly assessed that the Court’s reasoning failed to legitimise the individuation of the objectives of the Treaty’s norms and proposed a different – and in this author’s view, more legally based – interpretation of the objectives of the articles. See G. Beck, The Legal Reasoning of the Court of Justice and the Euro Crisis– the Flexibility of the Cumulative Approach and the Pringle Case, in Maastricht Journal of European and Comparative Law, vol. 20, 2013, p. 648.

\textsuperscript{15} P. Craig, Pringle and the Nature of Legal Reasoning, in Maastricht Journal of European and Comparative Law, vol. 21, 2014, p. 205. In the view of this author, the distinction between legal and teleological reasoning, which looks at the former as based on the interpretation of the texts of the norms and the latter at their objectives, must be significantly nuanced. There are three major ways of shaping those approaches, semantically, to define the scope of a body of law and to interpret constitutional norms, see ibid 203-212.

\textsuperscript{16} This is something that the CJEU has also done in past, looking for examples of the objectives of an entire category or body of law, such as the economic and social ones in gender discrimination legislation, see eg, Case 43/75 Defrenne v Sabena [1975] ECR 455; Case C–50/96 Deutsche Telekom v Schröder [2000] ECR I–743.

\textsuperscript{17} P. Craig, Pringle and the Nature of Legal Reasoning, cit., p. 220.

\textsuperscript{18} The role of this new principle in modifying the economic constitution of the EMU was analysed in-depth by K. Tuori and K- Tuori, The Eurozone Crisis. A Constitutional Analysis, Cambridge University Press, 2014, p. 119-136.
OMTs. The GFCC looked only at the immediate and textual objectives and found a violation of the Treaty’s provisions. Thus, it proposed a reading that reflected a conservative view of the main telos of the Maastricht compromise. The Court of Justice instead also looked at the indirect and ultimate objectives, i.e., saving the programme on teleological grounds.\textsuperscript{19} The divergent approaches adopted by those Courts seems confirmed by an examination of the judgement by the Federal Constitutional Court ending the OMT saga and by the recent referral regarding the Quantitative Easing.

My claim is that the ESM and the OMT have had a remarkable impact upon the fiscal balance in the Economic and Monetary Union that could be understood using the perspective offered by the theory of fiscal federalism. As this paper should indicate, on theoretical ground, multilevel systems are generally defined by peculiar incentives that are aimed at motivating actors to adopt disciplined behaviour. This could be particularly helpful to highlight how each aspect of the new instruments introduced in the Eurozone should be evaluated, based on the objective of financial stability. The incentive structure of fiscal federalism theory seems to be particularly useful in understanding the reasoning of the Court of Justice when it adopts an approach that is strongly influenced by a teleological perspective. The importance of such an aspect is particularly evident if we consider that the legal validity of the instruments relies on an evaluation of the kinds of behaviour by the actors that could result from them. As a consequence, the Court has defined several aspects of the Economic and Monetary Union that also have an implied value for the fiscal federalism system.

\textsuperscript{19} This was particularly emphasised by V. Borger, \textit{Outright Monetary Transactions and the Stability Mandate of the ECB: Gauweiler, in Common Market Law Rev}, vol. 53, 2016, p. 175. The peculiarity of both cases is that the CJEU found the goals of Articles 123 and 125 by looking at \textit{travaux préparatoires}: to submit a state’s budget policy to market logic when entering into debt. For an overview of the historical interpretation of the CJEU, see K. Lenaerts and J.A. Gutiérrez-Fons, \textit{To Say What the Law of the EU Is: Methods of Interpretation and the European Court of Justice}, in CJEL, vol. 20, 2013, p. 23-31.
The view of fiscal federalism is introduced in paragraph 2, particularly focusing on the works of J. Rodden. I selected this author for the utility of the analysis of the main troubles that arise in fiscal federal systems in order to understand the evolution in the Economic and Monetary Union that emerged in these judgements. The paragraph briefly discusses the relevant aspects of J. Rodden’s theory on fiscal federalism, focusing on two aspects: the perils of this kind of system and the kinds of incentives that could be adopted to resolve them. In paragraph 3, I recount the challenges and the structure of the system of incentives in the Eurozone. The following paragraph is focused on the reconstruction of the Pringle and Gauweiler cases; the main intent is to correctly individuate the focus of my research by highlighting the similar issues that the Court faced in interpreting Article 125 of the Treaty on the Functioning of the European Union and Article 123.1 of the Treaty on the Functioning of the European Union, in the two judgements. I will then test the contribution of fiscal federalism theory in interpreting the Court’s reasoning in paragraph 5 by showing how evaluations of the features of the programmes made in the judgements could be considered according to the theoretical frame. The new frame of incentives is tested by an examination of Ledra Adv. in paragraph 7. Afterward, the analysis of the judgement of the GFCC ending the OMT saga and the QE referral will help to show how far the divergence between national and supranational Courts is determined by the different interpretative approach to the Eurozone evolution and the role played by conditions and features of the instruments challenged in this process. The last paragraph will summarise the questions and draw conclusions from this analysis.

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2. Perils of Fiscal Federalism: Theoretical Frame

In political studies, there has been controversy about the applicability of fiscal federalism theories at the EU level. Generally, those doubts date back before the financial crisis and before the reform process implemented through the Six Pack, the Two Pack and the introduction of Assistance Mechanisms. The same author that this article mainly uses to highlight the perils of fiscal federalism raised some doubts about the applicability in the EU of this theory in his conclusions.\(^{21}\) However, the new legal framework, recent studies and the judiciary’s approach all seem to overcome those doubts.\(^{22}\)

In this paper, I will not address on theoretical ground the issue of the applicability of fiscal federalism theories to the Eurozone but I will rather try to highlight how far the use of that perspective could be helpful in providing in-depth explanations to the interactions between the new instruments adopted amidst the crisis and the provisions of the Treaties. The aim is not to solve – once and for all - the issue of the applicability of fiscal federalism theories to the Eurozone but to show that \textit{de facto} it operates according to similar logic. This perspective will help to show in a different light also the different interpretative outcomes of the reasoning of the CJEU and the GFCC, as reflective of diversified evaluations of pre-legal principles ruling the Eurozone.

2.1. An overlook on theory of fiscal federalism and its perils

The more widely accepted model of fiscal federalism was summarised in W. Oates’s book, \textit{Fiscal Federalism}\(^{23}\), which proposed a division of activities according to each one’s level of externalities. The \textit{ratio} of the distribution of powers is the so-called the

\(^{21}\) See J. Rodden, \textit{Hamilton’s Paradox}, cit., p. 278-279.
“decentralization theorem”, which aims to keep the decision process as local as possible, i.e. to internalise externalities at the smallest level of government possible to achieve better accountability. This kind of model primarily faces the problem of a trade-off between inter-jurisdictional and intra-jurisdictional efficiency, which can be summarised as follows: A larger jurisdiction diminishes spillovers, but it increases the misallocation of resources within the same. As pointed out by R.P. Inman and D.L. Rubinfeld, when facing economic shocks, this issue raises questions about the efficiency of the member states’ fiscal policies in offsetting local economic shocks and the desirability of this level of management; further, it raises questions about the kind of central government policies that should be preferred. The lessons those authors took from the U.S. example were very predictive of the struggle of the Economic and Monetary Union in the recent crisis. According to them, some level of inefficiency is inevitable in systems in which the member states have some form of control over their fiscal affairs: Particularly in the EU, the centralised monetary policy requires some form of fiscal policy to face state-specific economic crises.

In this paper, I will refer mainly to the perils of the theory of fiscal federalism, as proposed by J. Rodden. According to this author,

24 W.E. Oates, Fiscal Federalism, cit., p. 130. The centralised level should regulate public activities distinguished by significant externalities involving a spatially dispersed population. The local government should control activities with limited or absent spillovers.

25 See J.M. Quigley and D.L. Rubinfeld, Federalism as a Device for Reducing the Budget, in A.J. Auerbach (ed), Fiscal Policy. Lessons from Economic Research, MIT Press, 1997. The authors also emphasised the role of spillover effects in compromising the efficiency of the Tiebout model. Moreover, they considered that a national consensus on the minimum levels of guaranteed rights would imply that redistributive policies should also be considered among the central powers, at least in the form of minimum standards that leave some degree of local choice to the subnational levels in order to adapt them to jurisdictional preferences.


many federal systems have a widespread problem with fiscal indiscipline that is related to the behaviour of the subnational governments: They adopt excessive deficit spending policies and attempt to shift the costs to the central government or to other autonomies.\textsuperscript{28} However, there are also cases in which the state and local governments have adopted sound budgetary policies.\textsuperscript{29} The central issue is whether the incentive structures are properly organised: They must act as safeguards against widespread opportunism.\textsuperscript{30}

For the purposes of this paper, I summarise this approach by highlighting three major perils that systems of fiscal federalism must face: (1) misleading information about no-bailout commitments; (2) fiscal transfers and their effects on the budgetary behaviour of subnational governments; and their (3) distortive use of borrowing autonomy. Afterwards, I sum up the incentives according to their market and legal rationales.

In order to evaluate how these incentives work, Rodden proposed a “bailout game” that takes the behaviours of central and subnational governments into consideration.\textsuperscript{31} Basically, Rodden showed that a financial crisis evolves through several steps in which

\textsuperscript{28} See J. Rodden, G.S. Eskeland and. J. Litvack (eds), Fiscal Decentralization and the Challenge of Hard Budget Constraints, MIT Press, 2003, in which the cases of India, Nigeria, Russia and South Africa are proposed as the main examples of these troubles.

\textsuperscript{29} J. Rodden, Hamilton’s Paradox, cit., p. 3 proposed as examples the cases of the United States and Switzerland. It is worth noting that the Great Recession hardly tested the finances of some states in the U.S., and it evidenced a number of weaknesses in their financial constitutions, see M. Iannella, ‘U.S. States’ Fiscal Constraints and Effects on Budget Policies, in Perspectives on Federalism, vol. 8, 2016. To evaluate the kind of behaviour the central government would have, an element that is central in many analyses is the size of the jurisdiction: The bigger it is, the easier the access to bailouts for externality costs would be. These are the conclusions of D. Wildasin, Externalities and Bailouts: Hard and Soft Budget Constraints in Intergovernmental Fiscal Relations, in World Bank Policy Research Working Paper, 1997.

\textsuperscript{30} J. Rodden, Hamilton’s Paradox, cit., p. 5-6.

\textsuperscript{31} D. Wildasin, Externalities and Bailouts, cit.; R. Inman, Local Fiscal Discipline in U.S. Federalism, in J. Rodden, G.S. Eskeland and. J. Litvack (eds), Fiscal Decentralization and the Challenge of Hard Budget Constraints, cit., p. 35-84.
the subnational governments act; these steps are primarily based on the expected reactions of the superior level. The more credible the commitment to no-bailout, the more likely a subnational government will opt for the early-adjustment option: considering that subnational governments prefer to avoid taking charge of adjustment costs – for electoral reasons – and that they consider a correction paid by other jurisdictions’ citizens to be the best option. However, the central government could also find some advantages in an early bailout, instead of risking a default or being induced into a later one. The problems emerge because of a lack of information or misleading deficit information: The state government, without knowing the resolute or irresolute nature of the central government to its no-bailout commitment, could act in a way that will lead to one of the worst outcomes, i.e. late adjustment, late bailout or even default.  

This could be considered to be the first major peril of fiscal federalism: The incentives should provide the information necessary to ascertain the predictable behaviour of the actors.

Rodden also focused on the link between the intergovernmental fiscal systems and the credibility of a no-bailout commitment. To explain this aspect, the connection between intergovernmental grants and fiscal illusion must be highlighted: When policies are financed using that kind of funding, they seem to be paid by non-residents, thus leading to an increase in local expenditure. The subnational governments have little incentive to adopt sound budgetary policies, and they could adopt irresponsible behaviours for several reasons: (1) electoral expectations in linked systems look to the central government to resolve a crisis; (2) the subnational governments are

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32 J. Rodden, Hamilton’s Paradox, cit., p. 48-55. To confirm his theoretical reconstruction, the author applied this game to the financial crisis that occurred in the U.S. in the 1840s and to the behaviour of the actors in that situation. False expectations led several states to default, see B.U. Ratchford, American State Debts, Duke University Press, 1941.

confronted with the problem of a lack of flexibility in handling their budgets (hence, this increases the problems involved in facing a fiscal crisis, and in addition, it can be used as an excuse to invoke federal intervention); 34 and (3) there is strong political pressure by bondholders, banks and interested people on the central government to intervene. 35 This helps to reveal the second peril of fiscal federalism: Unlimited and unconditioned intergovernmental grants could lead to fiscal irresponsibility.

This occurs, in particular, if a high vertical imbalance is combined with borrowing autonomy in the subnational governments: The higher the connections between governments, the more the actors have expectations about some form of bailout. There are increasing externalities that make a central government guarantee credible. 36 Moreover, the markets could consider the central government as an implicit guarantor of the indebtedness of subnational governments. This perception could modify the borrowing conditions: Rating agencies also consider the intergovernmental links as a way of assessing the credibility of a debt discharge. This could distort fiscal behaviour, with particular reference to the appreciation of market-financed deficits by subnational governments. 37 Consequently, the third peril could be summarised as the adaption of the borrowing autonomy of subnational states to intergovernmental connections: The loans do not follow market financing logic, but instead evaluate lower interest rates and an implicit guarantor role to promote deficit-financed budgets. 38

35 J. Rodden, Hamilton’s Paradox, cit., p. 75-80.
36 Some studies have argued that in federal systems, the more remarkable the vertical imbalance, the more rational the bailout expectations are, see D. Wildasin, Externalities and Bailouts, cit.
37 J. Rodden, Hamilton’s Paradox, cit., p. 80-94.
38 J. Rodden, Hamilton’s Paradox, cit., p. 116-117.
2.2. Theoretical solutions: The systems of incentives

Federal systems face these perils in very different ways. Theoretically, there are two stable positions, and in addition, there is one that is actually more realistic. There are two main ways to induce sound budgetary policies: through the market or through rules. Hence, subnational governments could have a strong interest in adopting sound budgetary policies if investors and bondholders view them as sovereign. This implies that vertical imbalance is low, that the no-bailout commitment is credible and that the voters, together with the creditors, pressure governors to implement sound budgetary policies. On the contrary, it is possible to consider a system in which the rules prevent deficit-financed budgets: This mainly happens through the elimination of the borrowing autonomy of subnational governments and direct vertical intervention in their spending decisions. In this case, the central government imposes fiscal restraint through its legislative powers.

However, federal systems generally do not adopt either of these two extreme solutions: They mainly rely upon so-called “semi-sovereignty” options. In this system, subnational governments have some kinds of borrowing autonomy, and in addition, there are some kinds of vertical imbalances. On the one hand, the central government

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39 J. Rodden, Hamilton’s Paradox, cit., p. 94-103. In the following analysis, I will refer to the first as “market-based” and to the second as “rule-based” systems of incentives.

40 J. Rodden affirmed that, while rare, some examples of fiscal systems with pure dual sovereignty still exist, mainly to assert his final thesis: Institutions are not central in determining fiscal behaviour, and sound budgetary policies can be determined by pure market-based reasoning if the game is not manipulated by semi-sovereignty frameworks. See J. Rodden, Hamilton’s Paradox, cit., p. 251-268. While it is not the central topic of this paper, it is worth noting that one of the same examples proposed by the author, the U.S., has been recently described in critical terms because it has experimented with forms of implicit bailouts, see M.S. Greve, Our Federalism Is Not Europe’s. It’s Becoming Argentina’s, in Duke J Cons L & Pub Pol’y, vol. 7, 2011-2012. Moreover, several studies have also questioned the realistic portrait of the dual sovereignty model in fiscal federalism on theoretical grounds, see mainly D.A. Super, Rethinking Fiscal Federalism, cit., p. 2544.
faces problems in keeping no-bailout commitments because of externality costs. On the other hand, when it has to intervene in state budgetary decisions, it faces the legal problem of competence. \(^{41}\) Therefore, in order to avoid fiscal indiscipline, federal systems have had to adopt some combination of market and legal incentives: Also, when the central government has a constitutional right to vertical intervention, it has to introduce some kind of regulative limitation on its own interference to avoid the aforementioned risks. The rules adopted must propose one of these two kinds of incentives to avoid opportunistic behaviours.

### 3. The System of Incentives in the Eurozone.

In Pringle and Gauweiler and, particularly, in the aspects of the decisions concerning the interpretation of Articles 125 and 123 of the Treaty on the Functioning of the European Union, the Court of Justice had to similarly define the compatibility with rules in light of the political incentive that the ESM and the OMT can generate. To understand why the Court proposed this kind of approach, it may be useful to clarify how the challenged instruments modified the theoretical background of this sector. Traditionally, those articles have been considered as part of the 'ordoliberal' approach that provided the theoretical background of the constitution of the Economic and Monetary Union. \(^{42}\) As discussed below, in several respects, the

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42 K. Tuori and K. Tuori, *The Eurozone Crisis*, cit., p. 27-35. The authors performed an in-depth analysis of the influence of ordoliberal economists on the EMU economic constitution, and they described the Maastricht Treaty as a compromise in which Articles 123 and 125 of the TFEU (as numbered after the Lisbon Treaty) must fight fiscal profligacy and assure monetary stability. The ECB was considered as a counter-majoritarian institution to better assure monetary stability and division in economic policies that were ruled by majoritarian and democratic institutions in each state, see O. Issing, *Central Bank Independence and Monetary Stability*, Institute of Economic Affairs, 1993. Also Ioannidis assumed that the measures adopted to face the Eurocrisis provoked a constitutional transformation in the Eurozone, partially substituting market discipline with bureaucratic discipline: it is a similar approach to the one proposed in this paper,
reference of the Federal Constitutional Court of Germany in Gauweiler proposed a reading of Article 123 of the Treaty on the Functioning of the European Union that was fully consistent with such an approach.\textsuperscript{43}

Returning to fiscal federalism theory, the original framework of the Eurozone could be considered as very close to a fiscal federal system, which could be viewed as market-based with respect to the incentives that assure sound budgetary policies.\textsuperscript{44} The main rules of the economic policies were primarily intended to limit public actions and to allow market incentives to work. The system aims to provide clear information about bailouts; Article 125 of the Treaty on the Functioning of the European Union forbids them, so the actors should not seriously question the commitment because they had clear

that focuses instead on the theoretical assumptions of this evolution that could be detected analysing the system of incentives and the theory of fiscal federalism. See M. Ioannidis, \textit{Europe’s New Transformations: How the Economic Constitution Changed During the Eurozone Crisis}, in \textit{Common Market Law Review}, vol. 53, 2016, p. 1237-1282. Faraguna noted that the original “stability paradigm” of Maastricht was founded on the role of market to monitor and check the economic policies of States: that paradigm entered in crisis in the economic downturn and it had to be reconsidered, see P. Faraguna, \textit{La saga OMT}, cit., p. 569 – 573. A. Hinarejos considered that the European Union will face a choice between a "surveillance model" and a "classic federalism model" that are partially reflective of the two kinds of instruments of regulation ("market-based" and "rule-based" incentives) described in this paragraph, see A. Hinarejos, \textit{Fiscal Federalism in The European Union: Evolution and Future Choices for Emu}, in \textit{Common Market Law Review}, vol. 50, 2013, p. 1621–1642. However, both the theoretical reconstruction and the analysis of the cases provided in this paper show that instead of a choice between those two model, the goal is to find a proper balance of the two of them

\textsuperscript{43} The reference of the GFCC regarding the OMT was described in such a way in several paragraphs of A. Hinarejos, \textit{The Euro Crisis in Constitutional Perspective}, Oxford University Press, 2015, p. 22-23, 129-131, 149-151; see also V. Borger, \textit{Outright Monetary Transactions and the Stability Mandate of the ECB}, cit., p. 169-175.

\textsuperscript{44} In a similar way, D. Adamski considered Articles 123 and 125 TFEU as constitutional safety valves introduced in the Treaty to replicate the German pattern of macroeconomic policy based on price stability. According to Adamski, these valves were removed by the new disciplining mechanism, which is the same issue that this paper tries to resolve according to the fiscal federalism theory, see D. Adamski, \textit{Economic Constitution of the Euro Area After the Gauweiler Preliminary Ruling}, in \textit{Common Market Law Review}, vol. 52, 2015, p. 1486-1487.
information (remember the first peril in paragraph 2). The separation between monetary and economic policies and the autonomy of the European System of Central Banks and the European Central Bank in the former were key elements for defining a system with very low vertical imbalance. Economic policies were only coordinated at the supranational level and were partially limited by the Stability and Growth Pact; monetary policy could not be a factor in determining national agendas, because it was conducted by an independent institution with a pre-ordered objective, i.e., price stability. Those features of the Eurozone fiscal construction should avoid any kind of implied responsibility of the supranational level for states’ fiscal policies and prevent adaptive behaviours aimed at transferring costs to other jurisdictions (the second peril in paragraph 2). Lastly, Articles 125 and 123 of the Treaty on the Functioning of the European Union worked together to avoid adaptive borrowing strategies; neither other governments nor monetary institutions should interfere with the market evaluations of states’ bonds.45

The assumption of a market-based Economic and Monetary Union proved ineffective in the last crisis.46 This led to the introduction of new instruments, including ESM and OMT, that are paramount of a new balance of incentives within the Eurozone fiscal construction. After the crisis, two of the main pillars previously discussed were seriously questioned. The no-bailout commitment was substantially eroded by the development of the assistance plan. In my view, the European Central Bank’s intervention to help refinance state debts in secondary markets could seriously undermine the credibility of independent borrowing strategies by the state actors. The system of pure market logic has seen its two main legal anchorages, Articles 123

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45 This element defines what was called the stability paradigm of EMU, which is based on the assumption that overall stability can be reached, granting price stability and allowing market incentives to work, see M.J. Herdegen, Price Stability and Budgetary Restraints in the Economic and Monetary Union: The Law as Guardian of Economic Wisdom, in Common Market Law Review, vol. 35, 1999, p. 9

46 This has been considered to be a bad equilibrium which is unable to avoid the risks of sovereign default; as an example, see P. De Grauwe and Y. Ji, Self-fulfilling Crises in the Eurozone: An Empirical Test, in CEPS Working Document, No 367, June 2012, available at <www.ceps.be>, accessed 7 November 2016.
and 125 of the Treaty on the Functioning of the European Union, weakened. Moreover, it failed to meet the original assumption that assuring price stability at the central level and merely coordinating the states’ economic policies would be an effective way to assure stability in the Eurozone. The intermediate goal of the aforementioned articles proved to be insufficient to guarantee the ultimate objective, i.e., financial stability. The ESM and the OMT – and the legal challenges asserted against them – testify to the struggle between the intermediate and final objectives of fiscal federalism’s legal anchorage. The core of the issue is that those instruments have eroded market incentives, and to compensate, the system had to create a balance with an increase in legal incentives, i.e., the features that measures and conditions thereby contained.

4. Judgments at Stake

4.1. The Pringle Case

This article focuses mainly on the parts of Pringle and Gauweiler that present a similar teleological approach. However, in order to make it clear how this topic is connected with the other aspects of the judgements, an overview of both cases is necessary. The questions referred by the Supreme Court of Ireland in the Pringle case concern the validity of Decision 2011/199/EU, which modified Article 136 of the Treaty on the Functioning of the European Union and the interpretation of EU norms, to evaluate whether they allow the ratification of the Treaty Establishing the European Stability Mechanism by a member state.\(^{47}\) The questions required an analysis of the perimeters of the competence of the European Union concerning monetary policy and the coordination of economic policy.\(^{48}\)

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\(^{47}\) Pringle, §§ 24-28.

\(^{48}\) In fact, the simplified revision procedure under Article 48 TEU adopted to modify Article 136 of the TFEU is admissible only for part III of it and if it does not extend the competence of the EU. As a consequence of its formal intergovernmental nature, the ESM Treaty is also admissible only if it does not touch the EU’s exclusive competences, such as that regarding monetary policy. The problem is...
of Justice initially had to define the first area, as it implies an exclusive competence of the EU: In doing so, the Court faced the absence of a textual definition in the Treaty on the Functioning of the European Union.\textsuperscript{49} As a consequence, the boundaries of monetary policy also had to be determined by looking at its objectives and not only by examining the tools admitted by the Treaties.\textsuperscript{50} On this ground, the Court distinguished between the stability of prices and the stability of the Eurozone as a whole: The first objective marks the perimeter of monetary policy. Instead, actions that try to reach the second should not be considered as falling in that sector. As a consequence, “\textit{[t]he grant of financial assistance to a Member State however clearly does not fall within monetary policy}”\textsuperscript{51}, because it pursues a different goal. Moreover, it is strictly linked to the overall reform process of the economic governance of the EU, which has been aimed at addressing the consequences of the financial crisis as a tool for completing the preventive measures thereby provided with a successive mechanism.\textsuperscript{52} A financial assistance mechanism falls into the coordination of economic policy competence. The EU does not have exclusive power in this sector, and consequently, it is possible for a state to adopt this kind of instrument if there is no violation of the relevant Treaty articles that define this sector.\textsuperscript{53}

Regarding the specific analysis of the questions raised by the Treaty Establishing the European Stability Mechanism, the Court specified some other points. The intent was to assess the distinction

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\textsuperscript{49} Pringle, § 53.
\textsuperscript{50} This is not the position proposed in the View of the Adv. Gen. Kokott (paragraph 82), which focused on the task of the European System of Central Banks to describe the scope of monetary policy. For an analysis of the different approaches taken by the Court and the Adv. Gen., see B. de Witte and T. Beukers, \textit{The Court of Justice Approves the Creation of the European Stability Mechanism}, cit., p. 830-831.
\textsuperscript{51} Pringle, § 56-57. P. Craig, \textit{Pringle: Legal Reasoning, Text, Purpose and Teleology}, cit., p. 215-216 shows both the insufficiency of textual analysis and the role that teleological interpretation has in determining this evaluation.
\textsuperscript{52} Pringle, § 58-63.
\textsuperscript{53} Pringle, § 64-76.
\end{flushright}
between the role of the financing mechanism and the power to coordinate economic policy as it stems from Articles 2.3, 119-121 and 126 of the Treaty on the Functioning of the European Union. The core of the Court’s reasoning is the interpretation of the conditionality provided in the European Stability Mechanism: The Court of Justice looks favourably at those rules, considering them as a way to guarantee compliance with Article 125 of the Treaty on the Functioning of the European Union and with the coordinating measures adopted by the Union. Moreover, they do not clash with the excessive deficit procedure in light of the explicit clause of conformity in Article 13.3 of the Treaty Establishing the European Stability Mechanism.

The key point for my topic is the interpretation of the no-bailout clause as provided by Article 125 of the Treaty on the Functioning of the European Union. The Court of Justice engaged, first, in a systematic interpretation of this provision by looking at it in conjunction with the other articles of the Treaty on the Functioning of the European Union addressing economic policy, and in particular, Articles 122 and 123. The interpretation of those articles is drawn after a historical analysis that shows the telos of those provisions. The first conclusion that can be drawn is that “the aim of Article 125 TFEU is to ensure that the Member States follow a sound budgetary policy”. The scope of that norm is even more specific: The restraint on the possibility for a state to take charge of the financial obligations of another has the objective of guaranteeing that each member state will comply with market logic when it enters into debt. The restriction is a way of coercing the adoption of that logic. For its part, a market-based approach must be considered as a way to induce a state into sound budgetary policies. This led the Court to clarify the higher objective of the norm: “maintaining the financial stability of the monetary union”. The Court’s interpretation links the literal

54 Pringle, §§ 111-112, particularly the evaluation of the provision at Art 13.3 of the ESM Treaty.
55 Pringle, § 113.
56 Pringle, § 13.
57 Pringle, § 135. P. Craig, Pringle: Legal Reasoning, Text, Purpose and Teleology, cit., p. 217-220 showed that the main scope of this article is to offer an
restriction to its higher purpose. On this ground, the ban itself is redefined from the perspective of its objectives: Financial assistance is outlawed when it could compromise the main goal the norm is intended to guarantee, i.e. financial stability. This is the core of our topic: The Court defined the objectives and the perimeter of the restriction, and then applied this test of admissibility to the European Stability Mechanism. The assistance mechanism was considered to be in line with EU law because it implements the same goals as those of Article 125 of the Treaty on the Functioning of the European Union, as shown by the limits and conditions thereby provided.\(^{58}\)

4.2. The Gauweiler Case

In Gauweiler, the Federal Constitutional Court of Germany challenged the Outright Monetary Transactions programme adopted by the Directive Council of the European Central Bank\(^{59}\) on two major grounds: (1) whether the Directive Council had the authority to adopt the measure or whether it was an interference with member states’ competences;\(^{60}\) (2) whether the measure was compatible with the exchange. It gives fiscal autonomy, but it demands fiscal responsibility. Moreover, the author noted that it is mainly only on the ground of teleological interpretation that it is possible to save the ESM from the restraints of Article 125. This is the main confirmation of the aforementioned use of a textual and teleological approach in the Court’s reasoning.

\(^{58}\) Pringle, §§ 136-147.

\(^{59}\) For an analysis of the goals and means of the OMT programme, see Adamski, Economic Constitution of the Euro Area After the Gauweiler Preliminary Ruling, cit., p. 1453.

\(^{60}\) The question arose in the consideration of Article 119 TFEU and Article 127(1) and (2) TFEU and Articles 17 to 24 of the Protocol on the ESCB and the ECB as conflicting norms. See Gauweiler, § 10. The GFCC refers mainly to two doctrines: the ability to disapply acts of the EU that are manifestly in violation of competences and the ability to disapply acts that upset the fundamental features of the political and constitutional structures of the member state. The ultra vires review was originally proposed in Maastricht-Urteil (BVerfGE 89, 155 vom 12. October 1993, Az: 2 BvR 2134, 2159/92) and more recently proposed in Case 2 BvR 2661/06, Honeywell, 6 July 2010, para 61; see C. Möllers, German Federal Constitutional Court: Constitutional Ultra Vires Review of European Acts Only under Exceptional
prohibition of monetary financing under Article 123 of the Treaty on the Functioning of the European Union. First, the Court considered how broad the scope of the powers of the European System of Central Banks and the European Central Bank were. In their implementation of monetary policy, those institutions must act within the limits of the powers conferred upon them by primary law, and their acts are subject to review by the Court.\textsuperscript{61} However, a broad discretion was recognised: “Within that framework, it is for the ESCB, pursuant to Article 127(2) TFEU, to define and implement that policy”,\textsuperscript{62} particularly within the application of the principle of proportionality.\textsuperscript{63} It followed that the independence recognised for the banking system in the Euro system also encompasses the authority to determine the appropriate tools to reach the fixed objectives on its own in the perimeter of primary law.\textsuperscript{64} This discretion is particularly relevant, especially because the Treaties determine the objectives and the instruments of monetary policy that are available to the European

\textsuperscript{61} Gauweiler, § 41.

\textsuperscript{62} Gauweiler, § 37. The discretion for European institutions in matters involving complex assessments of an economic and social nature is proper in the case law of the CJEU, see, for example, Case C-667/13, \textit{Estado Português v Banco Privado Português} [2015] EU:C:2015:151, para 67 and the case law cited therein.

\textsuperscript{63} Gauweiler, § 68ff.

System of Central Banks, without defining what a monetary policy is intended to be.\textsuperscript{65}

As a consequence, in order to determine whether the measure addressed monetary policy or not, the Court was required to consider two aspects: its objectives and the instruments adopted to achieve them. The purposes of Outright Monetary Transactions, i.e. safeguarding the singleness of monetary policy and an effective mechanism for its transmission, fall within the scope of the powers conferred to the European System of Central Banks. Moreover, the instruments adopted were considered to be legitimate in light of primary law.\textsuperscript{66} Once the general frame has been clarified, attention should be paid to the relationships between monetary and economic policy in light of some specific aspects of the Outright Monetary Transactions programme. The clause of compliance with macroeconomic adjustment programmes established by the European Financial Stability Facility or the European Stability Mechanism does not change the nature of the instrument. In the Court’s view, this kind of condition certainly had an impact upon economic policy, but it must be positively considered, i.e. as a way of allowing a state to respect the commitment to adopt sound budgetary policies as implemented in those programmes.\textsuperscript{67} The programme was also validated through the use of the proportionality test: In this part of its

\textsuperscript{65} Gauweiler, §§ 41-45. As in Pringle, the reconstruction of competences has been interpreted variously: particularly the Adv. Gen., the German Federal Constitutional Court, and the CJEU proposed non-homogenous readings of the Pringle precedent and its influence on this subject, see A. Hinarejos, Gauweiler and the Outright Monetary Transactions Programme: The Mandate of the European Central Bank and the Changing Nature of Economic and Monetary Union, in European Constitutional Law Review, vol. 11, 2015, p. 567.

\textsuperscript{66} Gauweiler, § 54: “[T]he ECB and the national central banks may, in principle, operate in the financial markets by buying and selling outright marketable instruments in euro”.

\textsuperscript{67} Gauweiler, § 46-65. On the effects of the economic support of the OMT programme for both the Union and the states, see C. Gerner-Beuerle, E. Küçük and E. Schuster, Law Meets Economics in the German Federal Constitutional Court: Outright Monetary Transactions on Trial, in German Law Journal, vol. 15, 2014, p. 311.
reasoning, the Court clearly confirmed the discretion given to the European Central Bank in the monetary policy field.\textsuperscript{68}

The last part of the judgement is very germane to our topic: The Court analysed the compatibility of the Outright Monetary Transactions programme with the restriction on monetary financing under Article 123.1 of the Treaty on the Functioning of the European Union. In order to clarify the perimeters of the prohibition, the Court had to consider the objective of that rule, i.e. stimulating the member states to adopt sound budgetary policies.\textsuperscript{69} Hence, secondary market operations – like Outright Monetary Transactions – have been considered in light of the purpose of that norm. The Court set the prism to evaluate the admissibility of the European System of Central Banks’ operations very clearly: They are acceptable in so far as they do not “lessen the impetus of the Member States concerned to follow a sound budgetary policy”. This kind of limitation was also viewed as a direct consequence of the mandate for the European System of Central Banks to sustain general economic policies in the EU that could be undermined by a weakening of that incentive.\textsuperscript{70} As a result of this interpretative approach, the Court had to analyse the kind of political incentives that emerge as a consequence of the main features of the Outright Monetary Transactions programme. The political incentives became the basis for its legal validity.

\textsuperscript{68} Gauweiler, §§ 66-92. T. Tridimas and N. Xanthoulis, \textit{A Legal Analysis of the Gauweiler Case}, cit., p. 30-32 noted that the Court of Justice adopted a judicial deference favouring the ECB with respect to the definition and implementation of monetary policy.


\textsuperscript{70} Gauweiler, § 109.
5. The Role of Incentives as a Basis for Legitimacy

5.1. The system of incentives in the cases

In my view, to understand what the Court seems to do in Pringle and Gauweiler, it is necessary to keep the evolution of the incentive systems in mind. The Court of Justice’s teleological interpretation of Articles 123 and 125 and its evaluation of the main features of the challenged instruments seem to be consistent with the evolution of fiscal federalism, which was discussed above. From this perspective, the main outcome of the Court’s evaluation of these aspects should be considered to be the emergence of new systems of incentives, in which the legal incentives, as determined by the conditions and features of the programmes, have a pivotal role. To assess this point, it is worthwhile to engage in a thorough examination of the paragraphs of the judgements that evaluate the ESM and the OMT programme in light of Articles 125 and 123.1 of the Treaty on the Functioning of the European Union, respectively. I will briefly discuss the Court’s reasoning, and I propose an interpretation that considers the plausible perils and incentives that could be detected.

The starting point is the way in which the limits on monetary financing and bailouts have been interpreted. When the Court of Justice had to define their perimeters, it started by assessing their objective: ‘to encourage the Member States to follow a sound budgetary policy’. The admissibility of the instruments was considered through this prism, i.e., analysing the input they give to actors on fiscal behaviour. In the end, they were considered compatible with EU law because they did not clash with it, and in

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71 In political studies, there has been controversy about the applicability of fiscal federalism theories at the EU level. Generally, those doubts date back to before the financial crisis and before the reform process implemented through the Six Pack, the Two Pack and the introduction of Assistance Mechanisms. The same author that we mainly use to highlight the perils of fiscal federalism raised some doubts about the applicability in the EU of this theory in his conclusions, see J. Rodden, Hamilton’s Paradox, cit., p. 278-279. However, the new legal framework, recent studies and the judiciary’s approach all seem to overcome those doubts; as an example, see C.R. Henning and M. Kessler, Fiscal Federalism: US History for Architects of Europe’s Fiscal Union, cit.
some respects, they pursue the same objectives as Articles 123 and 125. By connecting them to the theoretical ground, it is clear that these articles were considered to be cornerstones of the incentive structure; their perimeters could not be defined only by looking at the provision; rather, they should be interpreted bearing in mind their ultimate goal, i.e., to avoid fiscal irresponsibility by the member states (which are defined as subnational governments in the theoretical frame). Therefore, when the Court interpreted the instruments, it did not only look at the meaning of the restraints and the compatibility of the actions explicitly provided, but mainly at the purposes: the instruments should prove to contain effective incentives to assure the ultimate objective.

5.2. The role of incentives in Pringle

The link is quite explicit in Pringle, in which the Court looked at the prohibition in Article 125 of the Treaty on the Functioning of the European Union as a way of ensuring 'that the Member States remain subject to the logic of the market when they enter into debt, since that ought to prompt them to maintain budgetary discipline'. The base of the restraint was founded upon market logic: The exigencies of refinancing debt should guarantee fiscal discipline. To assess the compatibility of the European Stability Mechanism with such instruments, the Court evaluated several aspects. First, it looked at Articles 14-18 of the Treaty Establishing the European Stability Mechanism, in which the means of intervention of the Stability Mechanism are defined. The Court pointed out that: (1) the credit lines provided by Article 14 or the form of loans set forth in Articles 15-16 in "no way implies that the ESM will assume the debts of the recipient Member State"; (2) there is a duty to repay with an appropriate interest rate; (3) the stability support facilities provided for in Articles 17-18 are another way of granting a loan, because the European Stability Mechanism acts as a purchaser that pays the price

72 Pringle, § 139.
73 As a result of Articles 13.6 and 20 of the ESM Treaty. Pringle, § 139.
for bonds determined in their secondary market. On the basis of this element, the Court could assess that the European Stability Mechanism would not act as a guarantor of member state debt, and that the member states will remain responsible to their creditors for their financial commitments. For this reason, the Court considered that the instrument did not clash with Article 125 of the Treaty on the Functioning of the European Union: It did not undermine the sound budgetary incentives thereby provided.

Subsequently, the Court looked at the conditions for European Stability Mechanism assistance in two ways: (1) those necessary for requesting the intervention of the Mechanism and (2) the measures that the assistance plan requires states to implement. With respect to the former, the discussion addressed the limits on gaining access to stability support: Article 3 of the Treaty Establishing the European Stability Mechanism restricts it only to situations in which the financial stability of the entire Eurozone is at stake. It is not a form of financing that states can request in any situation involving financial distress: At the last instance, it is not something that is directly linked to their own financial situation. Moreover, it is explicitly required that stability support must be provided under strict conditionality. The Court evaluated this element by recalling the part of the reasoning that addressed the problem of the distinction between monetary and economic policy: As mentioned above, these requirements had the declared objective of guaranteeing that the member states will comply with EU measures and requests that, ultimately, are intended to ensure sound budgetary policies.

In my view, the position adopted by the Court could be better understood if one considers that, as pointed out by several authors referring both to the European Stability Mechanism and other forms

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74 Pringle, §§ 140-141.
75 Pringle, § 138.
76 On the CJEU’s interpretation of Art 125 TFEU according to the theory of interpretation on three levels, textual, purpose and ultima ratio considerations, see V. Borger, The ESM and the European Court’s Predicament in Pringle, in German Law Journal, vol. 13, 2013, p. 129-132.
77 Pringle, § 142.
of assistance,\(^{78}\) this kind of intervention could be considered as an implied or partial bailout in economic terms. The interpretation of the Court partially resolved the danger that the European Stability Mechanism could question the central government’s resolution to maintain the no-bailout commitment by looking at the intentions and the accountability for actions according to the Mechanism. First, it is not EU assistance; rather, the states provide it between them. The states’ doubts about the Mechanism’s role as a debt guarantor were not legitimised because the same methods for interventions are provided by the Treaty Establishing the European Stability Mechanism, loans or credit lines. Moreover, the European Stability Mechanism leaves all market incentives in operation: In asking for its assistance, a member state should keep in mind that interest rates must be paid and that the rules of supply and demand regulate the price of its bonds. The interpretation of the Court of Justice partially reinforced the perspective that in the “bailout game”, the states have clear information: They do not have an expectation of a bailout by the supranational level, at least in formal terms, because of the forms of this assistance, which are horizontal, and because of the refinancing exigencies that still exist.

However, the Stability Mechanism creates a form of intergovernmental connection that could be exploited by the member states by evaluating their borrowing autonomy. Analysing it from the perspective of the fiscal federalism theory, it appears that while formally avoiding the scope of a bailout, the assistance plan seriously questions the efficiency of the market incentives that Article 125 guarantees to assure stability. It is necessary to avoid the danger posed by a loan strategy that voluntarily leads to the intervention of the

\(^{78}\) On the ESM, see V. Borger, *Outright Monetary Transactions and the Stability Mandate of the ECB*, cit., p. 189; G. Beck, *The Court of Justice, Legal Reasoning, and the Pringle Case: Law as the Continuation of Politics by Other Means*, in *European Law Review*, vol. 39, 2014, p. 243. Looking instead to comparative cases, see M.S. Greve, *Our Federalism Is Not Europe’s*, cit., p. 40-42, who, also referring to assistance provided to the states through the expansion of healthcare funds, asserted that applying *effet utile* reasoning has an effect equivalent to taking over a state’s financial commitments.
European Stability Mechanism, considering it to be a way to externalise debt costs to other jurisdictions.

The reasoning of the Court had the effect of introducing a new type of incentives, i.e., legal incentives, to assure the achievement of the ultimate objective. The first boundary is the limitation of access to stability support: it is an exceptional intervention, not one on which a state can rely. Moreover, it is not something that the states can pursue through their own actions, because it only partially depends on the states’ financial situations and is mainly a consequence of the overall Eurozone situation. On the other hand, through the process of support, the state also cannot exploit intergovernmental transfers to adopt fiscally irresponsible measures (which represents another peril noted in the theoretical section). From this perspective, the restraint is built up by strict conditionality; to have access to external funds, it is necessary to ultimately agree on a pre-determined behaviour that will guarantee sound policies. In this case, the perils are primarily addressed by direct rule restrictions on the functioning of this form of intergovernmental transfer.

5.3. The role of incentives in Gauweiler

Similarly, in Gauweiler, the Court seemed to evaluate how regulative aspects could be linked to political incentives in assessing their legitimacy.79 On a first formal level, the European System of Central Banks is authorised by the OMT programme to buy government bonds only in secondary markets, thus excluding these interventions from being considered as equivalent to measures for

79 Similarities between Pringle and Gauweiler, and between the instruments, i.e., the ESM and the OMT, have also been noted by J.V. Louis, The Emu After the Gauweiler Judgement and the Juncker Report, cit., p. 56-58. The author mainly assessed that both are related to the shift from crisis prevention to crisis management in EMU governance, which was first proposed after Pringle by A. Van Malleghem, Pringle: A Paradigm Shift in the European Union’s Monetary Constitution, in German Law Journal, vol. 14, 2013, p. 141.
financial assistance. However, in this kind of intervention, there must also be “sufficient safeguards (…) to ensure that the latter does not fall foul of the prohibition of monetary financing in Article 123(1) TFE”. The main concern is that this kind of provision could have an effect equivalent to that of a direct purchase of government bonds. This would be a violation of Article 123.1 of the Treaty on the Functioning of the European Union, because it would clash with its objectives. In this case, the Court was quite explicit in recognising the danger that the member states could adapt their borrowing policies to intergovernmental construction.

The Court of Justice evaluated several features of the Outright Monetary Transactions programme in order to assess the compatibility of the instrument to the Treaty provision: (1) the discretion possessed by the Governing Council of the European Central Bank in determining the initiation and the features of the intervention in secondary markets; (2) the delay between the discharge in the primary market and the possibility for the European System of Central Banks to jump into secondary markets; (3) the exclusion of any kind of early announcement about the decision to proceed to such purchases and the volume of the operation. As a consequence, the states could not be reasonably certain of a successive purchase of their bonds by the European System of Central Banks, especially in light of the absence of details concerning the timeline and

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80 Gauweiler, § 103. Particularly critical of this evaluation, considering that the nature of the OMT should be considered to be financial assistance that could have been granted under the ESM, is D. Murswieck, ECB, CJEU, Democracy, and the Federal Constitutional Court: Notes on the Federal Constitutional Court’s Referral Order from 14 January 2014, in German Law Journal, vol. 15, 2014, p. 147.

81 Gauweiler, § 102. In this case, the CJEU shared the perspective of the GFCC, i.e. it admitted the potential equivalent effect of the secondary market operation, but the OMT was considered admissible on substantial grounds. On this point see, A. Hinarejos, Gauweiler and the Outright Monetary Transactions Programme, cit., p. 569-571.

82 Gauweiler, § 100, which also referred to the Draft Treaty amending the Treaty establishing the European Economic Community, with a view to achieving an economic and monetary union, Bulletin of the European Communities, Supplement 2/91, 24 and 54.

83 Gauweiler, § 106.
the conditions of the operation. In the theoretical perspective that this article adopts, this appears to be an effective way of preventing the discharge of debt from being altered by the prospect of having a guarantee of a buyer in a second market that would play the role of an implicit guarantor. The states cannot rely on this prospect, and further, they must face a market evaluation when issuing debt: Market logic incentives are still considered to be operating to avoid a modification of the indebtedness strategy.

The Court decided to go a step further: Compliance with Article 123.1 of the Treaty on the Functioning of the European Union, which is interpreted also considering Articles 119.2, 127.1 and 282.2 of the same Treaty, requires the European System of Central Banks to do something more, i.e. it must avoid “lessening the impetus of the Member States concerned to follow a sound budgetary policy”. The Outright Monetary Transactions programme potentially clashes with such an incentive, mainly because it could be considered to be providing intergovernmental transfers. As pointed out above, in these hypotheses, we could individuate the main peril in the possibility that the states will exploit the opportunity for external sources of funding by modifying their budgetary policies. Several points of the analysis of the programme’s provisions by the Court could be considered as limits or conditions that can prevent actors from evaluating financing in a way that will lead them to adopt fiscally irresponsible behaviours. The Court of Justice mainly noted that the purchase of government bonds is allowed only when it is strictly necessary to guarantee the transmission of monetary policy and for this reason alone, and it will cease after these objectives are achieved. This element is particularly useful because it avoids two potential distortions that could prevent market incentives from working: that the member states could adapt their budgetary policies to an expectation of a purchase by the

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84 Gauweiler, § 104.
85 Gauweiler, § 107.
86 Gauweiler, §§ 109-111.
87 Gauweiler, § 112. The CJEU’s approach to the singleness concept was considered as heterodox to the traditional EU interpretation of this concept by D. Adamski, Economic Constitution of the Euro Area After the Gauweiler Preliminary Ruling, cit., p. 1473.
European System of Central Banks and that the interest rates of their bonds could be harmonised among the countries, and thus, not reflect their real financial situation. The Court explicitly recognised that the prospect of the limited, objective-focused transfer that is proposed by the Outright Monetary Transactions programme should prevent the states from adapting their budgets based on the prospect of an intergovernmental transfer. The limited perimeters of the European System of Central Banks’ purchases that are a consequence of the features of the programme noted by the Court are considered adequate to allow market-logic incentives to work. In adopting their budgets, the states must still try to seek financing in the market and must consider the punishment that creditors could impose in the event of macroeconomic imbalances.

Moreover, the Court noted several other relevant aspects: (1) the programme is limited to the bonds of states that are part of an adjustment programme and that have access to the bond market; the European System of Central Banks shall retain the ability to sell the purchased bonds at any time; a state with a financial imbalance which is so high that it is excluded from the bond market cannot participate in the programme; “full compliance with the structural adjustment programmes to which the Member States concerned are subject” is required in order to have the possibility to purchase bonds. Once more, the Court seemed aware of the danger of adaptive behaviour by the member states. The first two elements could diminish adaptive borrowing policies by the member states, and they are strictly connected to the aforementioned main features of the

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88 Gauweiler, § 113.
89 Gauweiler, § 114. For an analysis of the different approaches taken by the GFCC and the CJEU in evaluating several aspects of the OMT programme, see Borger, Outright Monetary Transactions and the Stability Mandate of the ECB, cit., p. 184-189.
90 Gauweiler, § 116.
91 Gauweiler, § 117.
92 Gauweiler, § 119.
93 Gauweiler, § 120. On the role of these conditions in satisfying the required elements that the GFCC retained as necessary to consider the OMT as compatible with German Constitutional Law, see D. Adamski, Economic Constitution of the Euro Area After the Gauweiler Preliminary Ruling, cit., p. 1482.
programme. Rather, aspects (3) and (4) are valuable means to prevent the member states from exploiting easy access to the credit provided through the programme in order to decrease their efforts toward fiscal consolidation. In this case, the features of programme appear to work to induce, through the input of market logic, compliance with the objective of sound budgetary policies.

The main institutional implication of the interpretation of Article 123 of the Treaty on the Functioning of the European Union is the passing of the insulation of monetary policies; the independent status of the Central Bank does not mean that it could not consider the financial implications and effects of its proposed actions, as this is part of its objectives. From this perspective, the OMT programme could hardly be configured as a violation of the monetary stability target, but its effects, in terms of the economic policy objectives, are quite evident. As pointed out by A. Hinarejos, overlap between monetary and economic policy are, in some measure, inevitable, and the Court’s approach depended upon its view of the Economic and Monetary Union and its future. The reading of Articles 123 and 125 as pillars of the incentive system of fiscal federalism, which is mainly used to achieve financial stability, could provide help in understanding what the Court of Justice seems to do in this judgement. The analysis of the conditions and features of the programme could be considered as an effective way to build up a new system of incentives, which is also characterised by elements of direct intervention in spending decisions and the curtailment of subnational autonomy, and as testifying to the introduction of rule-based incentives in the Economic and Monetary Union’s fiscal federalism. It also provides help in understanding why the involvement of the European Central Bank in the Troika and connections between programmes and conditionality are considered in a favourable way; this helps to guarantee homogeneity between the

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94 A. Thiele, Friendly or Unfriendly Act? The “Historic” Referral of the Constitutional Court to the CJEU Regarding the ECB’s OMT Program, in German Law Journal, vol. 15, 2014, p. 261 is particularly clear on this element.

95 See D. Adamski, Economic Constitution of the Euro Area After the Gauweiler Preliminary Ruling, cit., p. 1474.

96 A. Hinarejos, Gauweiler and the Outright Monetary Transactions Programme, cit., p. 575.
market and legal incentives for the states in the same direction, thereby assuring the ultimate objective of financial stability.

6. Follow-Up: Confirmation and Rejection

6.1. An overview of the Ledra Adv. case

The reshaping of fiscal federalism in the EMU has been recently tested in the Ledra case, involving the assistance programme granted to Cyprus by the ESM and the conditionality provided by the Memorandum of Understanding (MoU) of 26th April 2013. The two largest banks of Cyprus were insolvent, and thus, it was necessary to implement a plan to restore the sector: The state required assistance, which was provided through the ESM. The state decided to recapitalise the Bank of Cyprus and to dissolve the Cyprus Popular Bank, after consolidating all its assets in the first. Because of the implementation of this plan, the actors saw the value of their deposits significantly reduced. The appellants complained that the General Court considered that the Commission and the ECB do not have autonomous decision making power regarding the duties in the assistance plan. Therefore, the General Court did not consider the role of these institutions as the effective cause of the losses of the actors, which were determined by the decisions assumed by the Republic of Cyprus in the implementation of the assistance plan. Moreover, the appellants also claimed that the Commission failed to ensure that the MoU was compatible with EU law as required in Pringle:

97 Memorandum of Understanding on Specific Economic Policy Conditionality concluded between the Republic of Cyprus and the European Stability Mechanism (ESM) on 26 April 2013.

98 Ledra, § 42-43.

99 Pringle, § 174.

100 Ledra, § 45-47.
The Opinion of Adv. Gen. Nils Wahl was consistent with the approach of the General Court in several aspects. As the ESM Treaty is considered an international agreement outside the EU legal order, the mere assignment of tasks to EU institutions does not change the nature of acts in the ESM frame. In his view, the links existing between this frame and EU law are not considered enough to bypass the rigidity of the list of acts in this frame. Analysing the second argument of the appellants – i.e. that the Commission has a duty to guarantee compliance with EU law –, the Adv. Gen. distinguished between compliance and consistency: In the ESM frame, there is not a duty to comply with every aspect of the EU legal order, but only to assure that the measures thereby implemented are consistent with the actions for the coordination of economic policies as defined by the TFEU. It should not be possible to detect a right conferred to EU citizens from the Commission’s role of guardian of the Treaties set forth in art. 17.1 TEU.

The Court of Justice shared the approach of the Adv. Gen. regarding the first argument: Thus, the plea for an annulment action was rejected. However, it took a different approach to the second argument, finding that the tasks conferred by the ESM Treaty to EU institutions could not alter the essential character of the power conferred to them by the Treaties. The Commission’s role of guardian of the Treaties as set forth in Art. 17.1 TEU should also be exercised in this frame by assuring that the Memorandum of Understanding is consistent with EU law. From this duty, the Court considered that the General Court “erred in law in the interpretation and application of Article 268 TFEU and the second and third
paragraphs of Article 340 TFEU by holding, in paragraphs 46 and 47 of the orders under appeal, on the basis merely of the finding that the adoption of the disputed paragraphs could not formally be imputed to the Commission or the ECB, that it did not have jurisdiction to consider an action for compensation based on the illegality of those paragraphs”. The Court of Justice adopted an approach significantly divergent from the position of the General Court and of the Adv. Gen., considering that the inclusion of the paragraphs in the MoU and the inaction of the Commission to guarantee the conformity with EU law of the same could result in non-contractual liability under art. 340.2 TFUE. The judgement specifies the conditions for the existence of this liability: the unlawfulness of the conduct, damage and the existence of a causal link between the two. The violation of law is found on the ground of the applicability ratione personae of the Charter to EU institutions when they act outside the EU legal framework. The Commission, particularly, has a duty to assure the consistency of the Memorandum of Understanding with the fundamental rights guaranteed by the Charter that arises under both EU provisions – art. 17.1 TEU – and ESM provisions – art. 13.3-13.4 ESM Treaty. Once it resolved the issue of the scope of application of the Charter, the Court of Justice analysed the existence of a violation of the right to property in the referred question.

6.2. The role of incentives in Ledra

This is the part of the judgement that is more useful to our topic; the Court of Justice implemented a test of proportionality in the

108 Ledra, § 60.
111 Ledra, § 67.
restriction of property rights using the frame of fiscal federalism defined in the cases previously analysed. A restriction on property is admissible in so far as it meets the objectives of the general interest and it does not impair the core of the rights guaranteed.112 In this case, the objective of the Memorandum of Understanding – the stability of the banking system of the Euro area – is coherent with the ultimate telos of the EMU’s economic constitution, i.e., the stability of the Eurozone as a whole. As in the analysis of Article 125 TFUE in Pringle, the CJEU shared the approach proposed by the ESM to justify its interventions and its legitimacy. The links between the banking system of a country and the overall financial system of the Union are evaluated to justify the relevance of the intervention from the perspective of the overall stability. The risks of negative spill-over effects in other countries and sectors justifies the intervention of the ESM.113 The contents of the Memorandum of Understanding that were being challenged are not unlawful because they pursue a legitimate goal, and they restrict property rights in a proportionate way.114

The analysis of the interventions of the ESM and their consistency with EU law should be conducted according to the teleological approach as proposed in Pringle. In this context, the conditionality of the ESM evaluated by the Court of Justice that defines the system of legal incentives is central in two ways.115

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113 Ledra, § 72.

114 See the analysis of the measures at Ledra, §73. The role of the Memorandum of Understanding as a leverage to curtail the impunity of actions in the ESM frame has been marked by P. Dermine, The End of Impunity? The Legal Duties of ‘Borrowed’ EU Institutions under the European Stability Mechanism Framework, in European Constitutional Law Review, vol. 13, 2017, p. 374 – 376.

115 The teleological approach seems to be helpful in resolving the ambiguity about conditionality evaluations made by the Court of Justice, which was discussed, for example, before the Ledra case by A. Baraggia, Conditionality Through the Lens of the CJEU: A “Blurry” View, in Verfassungsblog on Matters Constitutional, 30 June 2016, last date accessed 27 March 2017, available at <http://verfassungsblog.de/conditionality-through-the-lens-of-the-cjeu-a-blurry-view/>
one hand, the ESM assistance is admissible in so far as it respects the conditions fixed in *Pringle* in the analysis of Article 125 TFEU. In *Ledra Adv.*, this means that this intervention is consistent with EU law in so far as it responds to an exigency to guarantee the overall stability of the Eurozone. On the other hand, there are also limits on the intervention of the ESM. The Memorandum of Understanding could propose measures that potentially conflict with other EU rights – including the fundamental ones guaranteed in the Charter – if they are valuable in establishing and promoting the overall stability of the Eurozone. Otherwise, the Commission should be considered responsible for a violation of EU law, and it could be liable to pay extra-contractual damages. This seems to be a clear confirmation of the central role played by incentives in the frame emerging after the reformation process; in ESM interventions, a memorandum of understanding should be read both through the lens of the necessity to stress the compatibility with Article 125 TFEU of the decision to intervene and proportionality in evaluating the consistency of its contents with other provisions of the EU legal frame.

6.3. The different perspective of the GFCC

In the judgement of the Federal Constitutional Court of Germany that followed the decision of the Court of Justice in *Gauweiler*, the Court tried to find a balance between acceptance of the new approach to the EMU economic constitution as proposed by the CJEU and the formal confirmation of the national court powers. Thus, it is another case that seems to be interpreted as testifying to the 'yes, but...' approach in the integration process.116 The Court assessed, first, its power in the identity and *ultra vires* reviews, to fix the standards of its review; if the complaints rights – under Article 38 sec. 1 sentence 1, Article 20 secs. 1 and 2 in conjunction with Article 79 sec. 3 – and the rights and obligations of the Bundestag regarding the European integration are impaired by the (in)action of the Federal

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Government. The GFCC criticised three aspects of the judgement of the CJEU that are reflective of the more relevant criticism about this case: (1) the weakness of the analysis made by the CJEU to consider the OMT as an instrument of monetary policies, (2) the use made by the Court of teleological interpretation, without questioning the declared objective, which eroded the principle of conferral, and (3) the lack of a proper analysis of the link between the independence of the ECB and the absence of democratic legitimation of its actions. However, the GFCC maintained that there was not a manifest excess of competences that could justify the use of ultra vires review. Particularly, the national Court strongly evaluated the paragraphs of the judgement in which the CJEU analysed the features of the programme that limit its expansive possibility to assess the legitimacy of the OMT. These elements became, for the Court of Justice, keystones in assessing the compatibility with Article 123 TFUE and for the GFCC as limits to justify the absence of an ultra vires act. The national Court explicitly stated that the programme is compatible with internal constitutional law until the framework conditions evaluated by the CJEU are met.

The strict parameters defined by the Court of Justice, including the motivation duties, assure the possibility of exercising jurisdictional control over the acts of the ECB. In the view of the GFCC, this is an element that assures that the OMT programme could not be used to exceed the scope of powers conferred to the ESBC without a judicial inquiry regarding those actions. Moreover, there is an adhesion to the evaluation made by the CJEU of the features of the intervention, to exclude the violation of Article 123.1 TFUE by an equivalent measure. However, this provision is considered as a fundamental rule

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117 2 BvR 2728/13, §§ 115-173.
118 2 BvR 2728/13, § 177.
119 2 BvR 2728/13, § 188.
120 2 BvR 2728/13, § 174. In a paper on this case, P. Faraguna also noticed the key role of limiting conditions imposed by the Court of Justice to intervene under the OMT programme to justify, in the reasoning of the GFCC, the respect of the constitutional principle under stress, si v. P. Faraguna, La sentenza del Bundesverfassungsgericht sul caso OMT/Gauweiler, in Diritti Comparati, Working Papers, 1/2016, p. 8-13.
121 2 BvR 2728/13, § 194-195.
that should be interpreted adopting a restrictive approach in the perception of the GFCC, 122 while the provision – as mentioned before – is considered as providing an intermediate objective – a first *telos* – in the interpretation of the Court of Justice. Consequently, while features of the programme are similarly central in the interpretation of the Courts, their role is more differentiated. The GFCC evaluated them in a 'conservative' way, i.e., to lessen the impact of the programme as interpreted in *Gauweiler*. The Court of Justice seems to use them in a process of an overall reshaping of the guiding principle of the economic constitution of the Eurozone, as elements to mingle reformed economic governance and compliance with Treaty provisions. 123

The European integration agenda, and particularly the fiscal one, is central also in the QE case referral; again, the GFCC formally suggests its role of a guarantor of the conformity between the actions of supranational institutions and its (and not an European one) view of the paradigm of integration on fiscal ground. 124 The criteria of conformity of ECB programmes to Article 123.1 TFEU as defined in *Gauweiler* are interpreted in a restrictive way; that is, legally binding hypothesis and not indicators of a reshape of an overall paradigm, as this research seems to suggest. 125 As a consequence the referral suggests two plausible violations of the European Union. On the one hand, the PSPP126 could create a *de facto* certainty of the intervention

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122 2 BvR 2728/13, § 201.

123 In a similar way, noting the different roles of the features of OMT in the approach of the CJEU and of the BverfG, P. Faragna, *La saga OMT*, cit., p. 591 – 592.


125 *Proceedings on the European Central Bank’s Expanded Asset Purchase Programme are Stayed*, cit., § 2 l. a).

of the Eurosystem in acquiring government bonds, so violating a punctual criterion determined in *Gauweiler*\(^{127}\). On the other hand, the PSPP could configure a violation of the ECB’s mandate; the GFCC proposed a vision of a rigid divide between monetary and economic policies that is potentially breached by the programme.\(^{128}\) This position seems to be quite dissonant in respect of the positive evaluation of interactions between these two policies proposed in *Gauweiler*. Moreover, the referral seems to restate a conflict between the GFCC and the CJEU that could be better clarified in the perspective of two different visions of the Eurozone fiscal framework that emerged in this research. The German Court would ensure the continuity of its traditional vision of fiscal integration agenda and it interprets the new instruments as exceptional and limited hypotheses; their evaluations by the CJEU and their conformity with the Treaties are considered closer to derogations, that should be interpret in a restrictive way to ensure the non-modification of the Eurozone fiscal framework. On the other hand, this article has shown that the approach of the Court of Justice could be better understood in the perspective of an evolution of the underneath fiscal framework that provoked the exigency to find a new balance between incentives. It is not predictable – and it is not the aim of this article – to define how this conflict will be solved, but it seems quite helpful to jump out of the punctual and detailed contrasts to show the origins of the two interpretative approaches.

7. Conclusions

This paper has argued that in defining the limits 'by objective', the Court reflected an evolution in Economic and Monetary Union that could be better understood using the lenses of fiscal federalism.

\(^{127}\) *Proceedings on the European Central Bank’s Expanded Asset Purchase Programme are Stayed*, cit., § 2 l. b). This aspect could prevent, in the view of the GFCC, market rule to continue to work. In a similar way, see M. Goldmann, *Summer of Love*, cit.

\(^{128}\) *Proceedings on the European Central Bank’s Expanded Asset Purchase Programme are Stayed*, cit., § 3.
In political studies, the Eurozone fiscal framework could be considered as very similar to a model of 'semi-sovereignty'; there is the borrowing autonomy of the states, and through the use of funding or norms, there are forms of vertical imbalance. However, although the system, particularly in the sectors interested in our topic, was originally very close to a model of market-based incentives, the ESM and the OMT have eroded such a vision. To face the perils of fiscal federalism and to avoid fiscal indiscipline, a new combination of market and legal incentives should be provided. Therefore, the Court of Justice had to address the passage to a more nuanced system, one in which market and legal incentives are further combined to influence 'the impetus of the Member States concerned to follow a sound budgetary policy'. In doing so, the Court had to consider how 'central incentives' can influence the behaviour of 'subnational governments', bearing in mind that their fiscal responsibility is a cornerstone of the financial stability of the entire EMU. In this evaluation, the conditions and features of the programmes have emerged as pivotal in assuring a new balance; they play the role of legal incentives in compensation for the loss of the market ones.

The divergence between the position of the CJEU and the GFCC are, in my view, partially determined by a different reading and approach to this evolution. This new trend in the approach to the EMU frame was not well received by the GFCC, which proposed a conservative reading of Gauweiler, both in the decision ending that saga and in the QE referral. On the other hand, in Ledra, the Court of Justice seemed to confirm this interpretative trend using a teleological approach to justify the proportionality of the conditions contained in the Memorandum of Understanding subscribed by Commission; they pursued the overall objective of the EMU’s economic constitution.

129 J. Rodden, Hamilton’s Paradox, cit., p. 251-268. For an in-depth analysis of this model and its issues, see par. 2.2

130 Using the terminology of the theoretical perspective offered in par. 3.
Abstract: The article aims to interpret the evolution of the Eurozone governance using the lenses of fiscal federalism theory. This perspective would help to understand what the Court of Justice of the European Union had to manage in its cases that faced the economic governance reform process. The focus is mainly on the interpretation made by the Court of some features of the instruments challenged in Pringle and Gauweiler from a theoretical perspective. The thesis is that such evaluations reflect an evolution in the relationship between the norms and political behaviour of actors in the Economic and Monetary Union. Adopting a fiscal federalism theoretical perspective, the cases could be read as reflecting a modification of the system of incentives to assure the responsible fiscal behaviour of the actors. The Eurozone originally relied on market incentives to assure the states’ sound budgetary policies. Today, the system presents a more mixed system of incentives, with legal incentives particularly emerging in the Court of Justice’s interpretation of Articles 125 and 123.1 of the Treaty on the Functioning of the European Union. The explanation of this pre-legal evolution helps to understand the divergence between the interpretation of the Memorandum of Understanding as proposed by the Court of Justice in Ledra Adv. and the different approach proposed by the German Federal Constitutional Court in the judgement ending the Gauweiler saga and in the referral regarding the Quantitative Easing.

Keywords: Eurozone economic governance; Cjeu and eurozone governance; Fiscal federalism theory and its applications; Judicial interpretations of Eurozone evolution.

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