

## Policy Brief

# The proof of the pudding

## Imposing financial measures for rule of law breaches

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#RuleOfLaw

#SuspensionOfFunds

#Conditionality

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The EU's rule of law toolbox is growing, not just in theory but also in practice. At the same time, the Russian war in Ukraine has made abundantly clear the importance of protecting rule of law and democracy also at home. In this Policy Brief, Thu Nguyen maps the tools the EU has at its disposal to impose financial measures against member states that breach the rule of law. By illustrating the potential scale and scope of those instruments, she shows that the window of opportunity to leverage EU money against member states to enforce compliance with rule of law has never been bigger.

### Introduction<sup>1</sup>

The rule of law has been a persistent problem in some EU member states, first and foremost Poland and Hungary. At the same time, it may be slipping down the agenda as geopolitical considerations take centre stage with the Russian invasion of Ukraine. The temptation to cast a blind eye is real. Poland has been bearing the brunt of taking in Ukrainian refugees fleeing the war to the EU – the country alone has so far taken in [more than 3.4 million](#) and will require financial assistance from the EU to deal with these numbers. Hungary, on the other hand, is opposing an EU-wide ban on Russian oil imports by citing the major adverse economic impact such a ban would impose and [asking for EU money](#) to deal with what prime minister Orbán has called a 'nuclear bomb' for the economy.

But to let member states off the hook for rule of law breaches for geopolitical reasons would be a mistake. Not only has the Russian war in Ukraine made abundantly clear the importance of protecting rule of law and democracy at home. But also a debate on any EU enlargement towards the East inevitably will have to take place against the backdrop of the question whether the EU has functioning ex post conditionality mechanisms in place to avoid any repeat of historic mistakes.

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<sup>1</sup> Many thanks to Eulalia Rubio for the valuable comments and feedback.

The question of how to protect the rule of law in the EU has thus taken on a new and more toxic ambiguity. At the same time, the EU's rule of law toolbox — beyond the article-7 procedure that remains blocked for the foreseeable future — is expanding not just in theory but also in practice, in particular when it comes to leveraging EU money to enforce the rule of law. Thus, on 27 April 2022, the Commission triggered its conditionality mechanism for the first time against Hungary, which ultimately could see (some of) its EU funds suspended.

So, key questions are how the EU institutions can make the most of the available instruments and where there are gaps that need to be addressed. This policy brief maps the tools the EU has at its disposal to impose financial measures on member states that breach the rule of law. By focusing on the two most relevant examples — Hungary and Poland — it illustrates the potential scale and scope of those instruments and shows that the window of opportunity to leverage EU money against member states to enforce compliance with rule of law has never been bigger.

### **Imposing fines under infringement proceedings: time consuming and financially not harmful, but politically shielded**

Infringement proceedings are a [well-established](#) instrument in the EU. Under article 258 TFEU, the European Commission can bring them against member states for failure to comply with EU law. The procedure has different stages, starting with a letter of formal notice by the Commission, in which it sets out all its legal complaints. The member state in question is then given time to submit its observations. If no agreement is reached, the Commission issues a reasoned opinion, stipulating a period for compliance by the member state. Should the member state fail to comply the Commission may bring the matter before the European Court of Justice (ECJ). It is only after the Court has handed down a judgment, with which the member state in question does not comply, that the Commission can ask the ECJ to impose fines under article 260 TFEU.

Infringement proceedings are not only a [useful tool](#) to enforce the rule of law but also have a solid legal basis in the Treaties with formalised procedures. In comparison with other financial measures at the EU's disposal to respond to rule of law breaches, three factors are important to note:

- First, any infringement action takes time. The average length of an infringement proceeding was [37.3 months](#) in 2020 – or more than three years. This is far longer than any other procedure available to impose financial measures.
- Second, for the Commission to start an infringement action there must be a breach of the member states' obligations under the Treaties. While the question of what these obligations entail has been interpreted more broadly by the Court in recent times - e.g. to include article 19 TEU or the EU Charter on Fundamental Rights – this requirement still narrows down its scope of application.
- Third, imposing fines in infringement proceedings is not a given. On the one hand, it is up to the Commission to request the Court to impose a fine in infringement proceedings but it does [not systematically do so](#) – it does not ask for a fine at the end of each and every case. On the other hand, it is at the Court's discretion whether it grants the Commission's request for a fine. A fine can take the form of either a lump sum or penalty payments, which the Commission calculates [based on three non-binding criteria](#): the seriousness of the infringement, its duration and the wealth of the member state combined with its institutional strength. The ECJ, meanwhile, is not bound by the Commission's method of calculation.

Overall, infringement proceedings are both a useful and frequently deployed instrument. This is not least because their very legal nature can better shield them from more overtly political attacks than under other instruments. At the same time, they have a narrower scope for application than other tools and are very protracted – taking up time in which rule of law problems can seriously deteriorate before any fine can be imposed.

Critically, however big the fines in recent cases, they moreover [do little harm to national budgets](#). Even the daily €1m penalty that the ECJ [ordered](#) against Poland for each day it continued to fail to comply with its earlier order on the Disciplinary Chamber of the Supreme Court scarcely hurts government coffers, in particular if compared to other instruments at the EU's disposal.

### **Suspending funds under specific programs under the MFF: effective, but small scale**

It has been [argued in the past](#) that previous Common Provisions Regulations (CPRs) have consistently provided the Commission with the powers to suspend EU funds to member states violating the rule of law. The CP Regulation sets the rules for the funds under shared management, including cohesion funds. But the clauses pertaining to the suspension of these funds have never been used for rule of law breaches. What the Commission has done, however, is use rules pertaining to *specific* EU funding programs that allow it to suspend grants to member states.

For example, in July 2020, the Commission withheld funding amounting to between €5000 and €25000 from six Polish cities because they had adopted “LGBT-free” zones. The funding program involved is part of the [Europe for Citizens](#) project, which is designed to support initiatives strengthening remembrance of European history and enhancing civic participation at EU level. Specifically, the project's [call for proposal](#) required the relevant program to be ‘accessible to all European citizens without any form of discrimination on grounds of sex, racial or ethnic origin, religion or belief, disability, age and sexual orientation’. The Commission view was that the ‘LGBT-free’ municipalities failed to meet these requirements and thus rejected their applications. The Europe for [Citizens project has since been replaced by the new Citizens, Equality, Rights and Values \(CERV\) programme](#) under the Multiannual Financial Framework (MFF) 2021-2027. In September 2021, the Commission also successfully [threatened](#) to suspend up to €1.5bn in cohesion funds from ‘LGBT-free’ regions in Poland.

The effectiveness of these measures might well be queried given their often minor scale. But they remain important for two reasons:

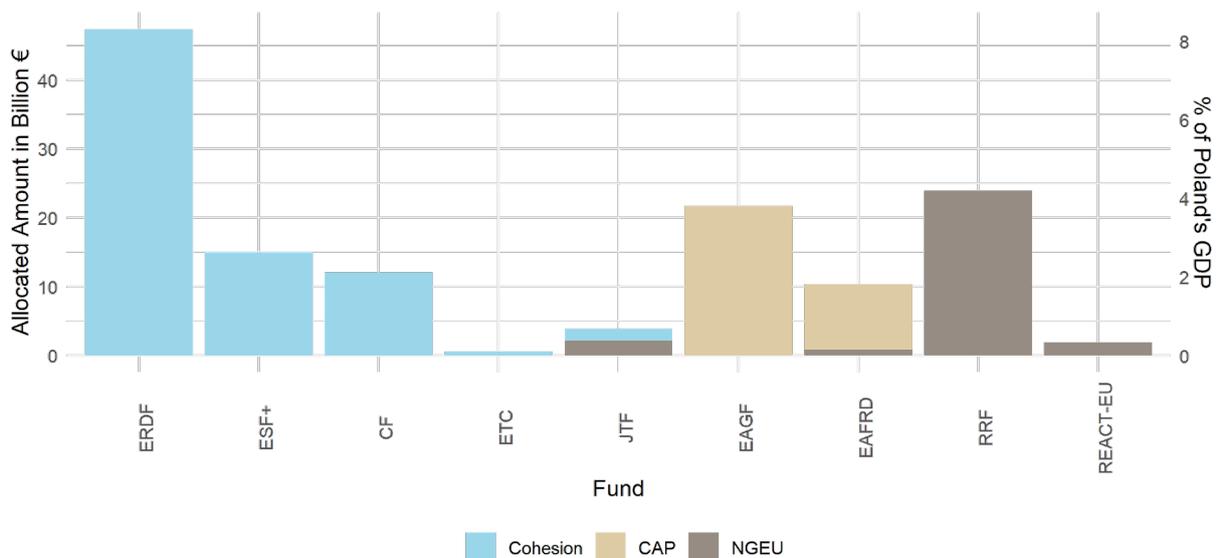
- First, when it comes to EU programmes under central management, the decision on whether to approve funding for action grants is a decision in the sole hands of the Commission that has immediate effect. It is thus an efficient tool, even if on a small scale.
- Second, they are effective, either for economic reasons or as an act of naming and shaming. In fact, some Polish regions have [revoked](#) their LGBT-free declarations when faced with the loss of EU funds.

Using specific funds to tackle specific rule of law problems related with the management of EU funds at local level can indeed be very effective: not only are the decision-making procedures uncomplicated but they also allow for targeted actions. This option should continue to be explored alongside other bigger and better-known instruments bearing in mind it is unlikely per se to trigger changes on a larger scale.

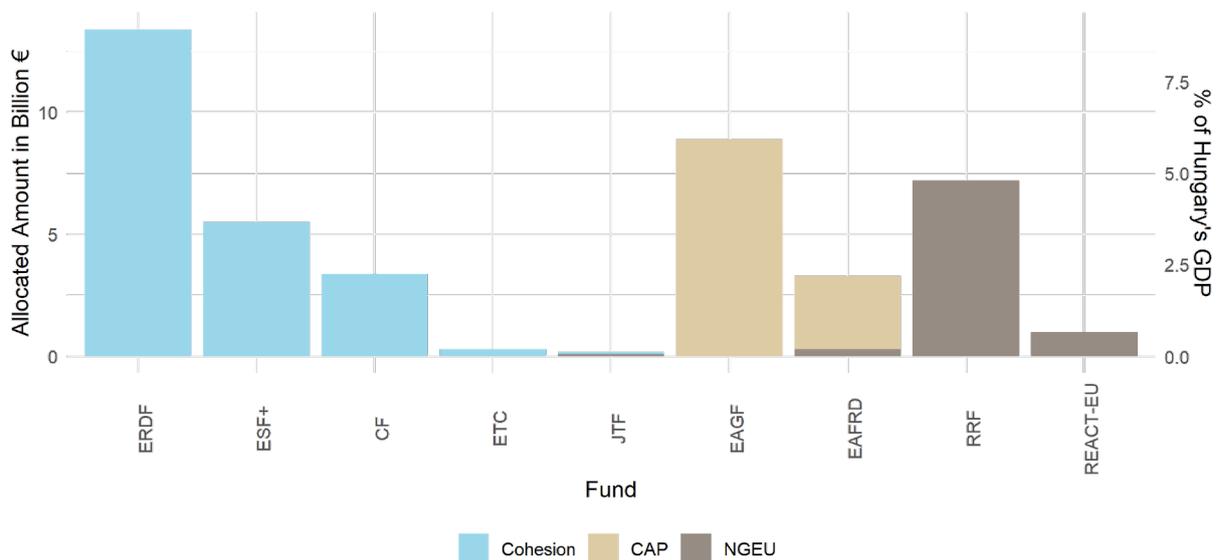
**Suspending funds under the rule of law conditionality mechanism: high hopes, but still unclear scale**

In January 2021, the EU’s [new rule of law conditionality mechanism](#) finally entered into force after years of controversial negotiations. On 27 April 2022, the Commission triggered the mechanism, which links payments of EU funds to member states to respect for the rule of law, for the first time against Hungary. Two conditions must be fulfilled if the EU is to suspend or reduce funds to member states: (1) There are breaches of the rule of law in a member state, and (2) these breaches must affect or seriously risk affecting the sound financial management of the EU budget or protection of the Union’s financial interests in a sufficiently direct way.

The mechanism applies to all EU funds under the MFF and the Recovery Instrument (RI). Measures can range from payments suspension via non-disbursements of loans to the reduction of an economic advantage. The tables below show the amount of EU money allocated to Poland and Hungary under the different funds. The two countries serve as examples to demonstrate that there is a lot of money the EU can, in theory, hold back if it wants – and that it actually already does with the RRF as will be explained further below.



Data: European Commission (2022), Eurostat (2022), in current prices



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If the Commission believes action is warranted under the [regulation](#), it first sends a written notification to the member state in question, setting out the facts and reasons for its finding. The member state has up to three months to send its observations, including proposals for remedial measures. The Commission subsequently decides within one month whether to propose sanctions to the Council, in which case the member state similarly has a month to submit fresh observations, notably on the sanctions' proportionality. The Commission once more has a month to submit a proposal for an implementing act on financial measures to the Council. The Council in turn must adopt its own final decision within another month by qualified majority.

High hopes have been attached to the rule of law conditionality mechanism ever since its adoption, even though the Commission's delay in applying it has somewhat dampened enthusiasm. Now two key issues remain:

- First, the procedure is lengthy: from the moment of notification until measures are imposed it takes at least five months and up to nine months if all available time frames are fully exhausted by the different parties. Given that Hungary will likely not want to rush the procedure and that the Commission has an interest in using all the afforded time to build a solid case, it is possible that it will take until the end of 2022 or the beginning of 2023 until sanctions are imposed.
- Second, the question of the scale of the measures arises. Both the regulation and the Commission's own [Guidelines](#) on the application of the mechanism, published in March 2022, emphasise that remedial measures taken under the mechanism must be [proportionate](#). This means that they must be limited to what is strictly necessary given the actual or potential impact of the rule of law breaches on the EU budget and take into account their nature, duration, gravity and scope. The more prolonged the breaches and the more systemic and widespread, for example, the more likely they are to have a budgetary impact. The Commission has [cited](#) 'systemic irregularities, deficiencies and weaknesses in public procurement procedures' as grounds for triggering the mechanism against Hungary. But what this exactly means for the size of funds that the Commission can or will propose should be frozen is not yet clear. In the end, the lack of clear indicators means that a great deal of discretion is left to the Commission in determining the scale of the sanctions proposed.

The procedure against Hungary will thus function as a test case for the mechanism. There is, on the one hand, a risk that the Commission will only target a small part of EU funds allocated to Hungary, thereby treating the mechanism somewhat [akin to an anti-corruption mechanism](#). The other risk, on the other hand, is that the Commission proposes a commensurate penalty, which is, however, rejected by the Council for geopolitical reasons, such as to convince Hungary to give up its veto on sanctions against Russia.

This would not set a good precedent. The rule of law mechanism is [not a silver bullet](#) to undo all previous rule of law breaches. But it is the only horizontal mechanism available to the EU to link rule of law breaches to the suspension of EU funds. The Commission should therefore set the bar high here and propose financial measures of a sufficient scale to impact the Hungarian budget: not just to sanction that member state but also to deter all others from setting out on a path that would force the Commission to trigger the rule of law mechanism against them in the future.

### **Withholding funds under the Recovery and Resilience Facility: effective and powerful, but limited in time**

In addition to the regular rule of law instruments, there is also the option to leverage the Recovery and Resilience Facility (RRF) against Poland and Hungary specifically. The RRF is the centrepiece of the EU recovery instrument, through which up to €723.5bn (at current prices) can be channeled to the member states in grants and loans. To tap into the money, member states must submit national recovery and resilience plans (NRRPs) to the Commission, which must, inter alia, also ‘effectively address all or a significant subset of challenges identified in the relevant country-specific recommendations’ (CSRs) of the European Semester. The CSRs for both [Poland](#) and [Hungary](#), for example, contain clauses regarding judicial independence.

The NRRPs are approved by the Council with qualified majority by means of an implementing decision upon proposal of the Commission. Once the NRRPs are approved, the allocated grants (and loans) are only disbursed after the member states have implemented their relevant reforms and investments. National governments can submit a request for payment twice a year. Only if the Commission concludes that the member state’s progress in achieving its plan is satisfactory does it approve, after an opinion of the Economic and Financial Committee, the payment.

That means that no RRF funds are transferred to the member states without prior reforms, including rule of law reforms. Critically, if the Commission is not satisfied with the way the member state has implemented the relevant milestones and targets, it may suspend the payment. The member state then theoretically has six months to take the necessary measures to fulfill them. Or its grants will be reduced. Similarly, if 18 months after Council approval of the NRRPs the member state has made no tangible process in carrying out its plan, the Commission terminates the agreement altogether and any pre-financing already received will have to be repaid – hardly a problem for Poland and Hungary, however, as neither has received any pre-financing.

The RRF process is very stringent when it comes to payment in return for reforms. The crucial question is therefore what reforms are written into the plans. As of mid-May 2022, neither the Polish nor the Hungarian NRRP has been cleared by the Commission. In particular for Poland, Commission President von der Leyen in October 2021 cited [three conditions](#) for approval: dismantling the Supreme Court’s disciplinary chamber – at the heart of the dispute between the EU and Poland for years –, ending or reforming the disciplinary regime and starting the process of reinstalling the judges dismissed on the basis of said regime.

The delay in approval causes several problems for Poland and Hungary beyond the obvious issue that sorely needed money is currently missing from government coffers:

- First, both countries lost out on billions of euros of pre-financing in 2021. Out of the €23.9bn and €7.2bn respectively, 13% could have been paid out by 31 December 2021 as pre-financing, without any further conditions beyond the approval of the NRRP. Now, before any money can flow, the government will have to achieve their relevant milestones and targets first.
- Second, the delay also means a much tighter timeframe to achieve those milestones and targets. Under the RRF regulation, these must be implemented by August 2026. This leaves member states with little time to fulfil the often very wide-ranging reforms in the first place. The later the Polish and Hungarian NRRPs are approved, the more

difficult it will become for them to implement all the necessary reforms on time to receive the full amount of their grants before the end of 2026.

- Third, member states should, in principle, apply for loans before 31 August 2023, which must be approved by 31 December 2023. Under the Commission's new [REPowerEU plan](#), this timeline will be fast-tracked: member states are asked to communicate their intention to request a loan within 30 days of adoption of the new regulation amending the RRF in order to speed up their allocation. RRF loans are attractive because they offer advantageous financing conditions and low interest rates. This might gain salience given the financial needs that are emerging in the member states because of the war in Ukraine.
- Finally, the Commission is proposing to integrate REPowerEU, which is aimed at reducing EU dependency on Russian fossil fuels, fully into the RRF. There is a significant overlap between RRF and REPowerEU money: The largest share of REPowerEU would, in fact, be untapped RRF loans. The rest would come from selling ETS certificates and reshuffling other EU funds. The proposal of the Commission to channel REPowerEU through the RRF has implications for rule of law: Poland and Hungary will need approval of their (amended) NRRPs not just for investments to recover from the pandemic but also if they want to use EU money to wean off Russian energy exports. This further raises the pressure on the governments to comply with the Commission's demands.

Overall, withholding approval of the NRRPs is the most powerful tool in the hands of the Commission. To enforce rule of law in Poland and Hungary, it can leverage very large sums which are needed not only for recovery from the pandemic but now also for reducing dependency on Russian oil, should the Parliament and Council agree with the Commission's proposal. What is more, it is the only instrument that takes immediate effect: There is no lengthy procedure to go through to *not* approve the plans, nor does the Commission depend on the support of the member states. A majority in Council will only be needed to approve the plans.

At the same time, the RRF is a tool with a short shelf life. Money can only be disbursed until the end of 2026, after which any Commission leverage via the RRF in its current form will no longer exist. Therefore, strictness is now as much of the essence as speed: Leverage under the RRF is only as strong as the plans are strict. The Commission should therefore eschew any compromise with Hungary or Poland that would defeat the conditionality elements of the RRF. The RRF as a rule of law instrument is, as things now stand, an exceptional opportunity that should not be lightly given up.

### Overview of possible financial measures for rule of law breaches

Instrument	Procedure and decision-maker	Possible outcome	Effectiveness
Recovery and resilience facility	COM withholds approval of NRRPs by not proposing implementing decision to Council; at later stage COM can also withhold tranches for non-implementation of NRRP milestones and targets	Suspension of RRF payments and loans	Immediate effect, but limited in time (only until 2026)
Rule of law conditionality mechanism	Council decides with QMV, on proposal of COM, on financial measures for breaches with sufficiently close connection to EU budget	Suspension of payments, commitments and/or loans	Neither very lengthy proceedings nor immediate effect, still open questions as to scale
Suspension of funds under specific programmes	COM withholds specific EU funds for non-fulfillment of criteria laid down for the applicable programmes	Suspension of payment of specific programmes	Immediate effect, but smaller scale
Infringement proceedings	COM brings action against MS before ECJ for failing to fulfill Treaty obligations (art. 258 TFEU); ECJ imposes financial sanctions for non-compliance with judgement (art. 260 TFEU) upon COM request	Payment of lump sum or daily penalty	Lengthy proceedings, narrow(er) in scope, but politically more shielded

### Conclusion

Rule of law has been a long-standing issue in the EU. In the last two years the EU's rule of law toolkit has expanded substantially, with new instruments to hand that can be used to leverage EU money on a large scale. Now the proof of the pudding is in the eating: It is for the Commission and the member states to wield them effectively and consequently. This means two things: First, employing the rule of law mechanism to its fullest extent; second, continuing to make use of the strict conditionality the RRF provides.

There is a trap to be fallen into that the war in Ukraine warrants unity in the EU as well as financial support for member states hardest hit by the refugee and energy crises but at the expense of precluding Brussels from enforcing financial measures against them – even when they blatantly breach the rule of law. Such a conclusion would be fatal. The Russian war in Ukraine hammers home the crucial importance of protecting the rule of law and democracy. These values cannot be bartered at home in the name of protecting them elsewhere.

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