POLITICAL INTELLIGENCE

Understanding the EU's new rule of law conditionality regulation

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Introduction

On April 27 the European Commission officially launched its new rule of law disciplinary procedure for the first time against Hungary, just a couple of days after populist leader Viktor Orban secured a fourth consecutive term as prime minister. The so-called conditionality regulation empowers the European Union to protect its funds from mismanagement resulting from breaches of the rule of law, one of the key principles of the Union. The use of the untested mechanism, which was agreed by all 27 EU leaders in late 2020, could result in billions of euros of EU payments being withheld from Hungary if the Commission proves the funds are at risk.

The decision to use the instrument followed criticism from some European Parliament lawmakers that the European Commission had been slow to react to allegations of corruption of EU funds and erosion of democratic rights, judicial independence, and media freedom in Hungary since Orban came to power in 2012. Hungary was the second most corrupt country in the EU in 2021 after Bulgaria, according to Transparency International's annual corruption perceptions index. In its latest report, US advocacy group Freedom House categorised the country as "partly free", after declaring in 2020 that Hungary was no longer a democracy.

Commission President Ursula Von der Leyen has said there can be no compromise when it comes to respecting the rule of law in the EU and has championed the new mechanism as an additional tool for ensuring compliance across the Union. The decision to deploy the new sanction regime against Hungary signals a fresh determination in the Commission and among member states to hold countries responsible for backsliding on the rule of law and marks a significant moment in the development of the EU's democratic credibility. While the move against the Kremlin-friendly government of Orban further underscores the growing isolation of Hungary, it comes at a sensitive time for the Union as it seeks to maintain unity in the face of Russia's invasion of Ukraine.

Although EU officials have, at the time of writing, yet to say how much money they could withhold from Hungary using the mechanism, the member state has potentially a lot to lose as it is one of the largest beneficiaries of EU funds. Under the 2021-2027 budget, Hungary is set to receive €36bn, equivalent to about 28 percent of its gross domestic product in 2020. The Commission is already withholding approval for a €7 billion recovery plan for Hungary over corruption risks.

This Dods EU Political Intelligence report tells you what you need to know about the conditionality regulation: what it is and how it can be applied; its origins and next steps; and how it complements other EU measures to defend the rule of law. This report does not seek to provide analysis on the specifics of the case against Hungary.

What is the conditionality regulation and how is it triggered?

The rule of law conditionality mechanism is the newest instrument at the Commission's disposal which aims to protect and defend the rule of law across its member states. It is designed to link the disbursement of EU funds with adherence to the Union's rule of law principles. The instrument can be used if rule of law breaches in a member state affect or pose a serious risk to the EU's management of the budget or the EU's financial interests in a "sufficiently direct way". Thus, a direct link between the breach in question and the EU budget must be proven. The instrument complements other measures that protect EU funds, such as checks, audits, financial corrections, and investigations by the European Anti-Fraud Office (OLAF). The legal basis for the mechanism is the Rule of Law Conditionality Regulation and the guidelines on its application provide useful details on the instrument and its elements.

When it comes to the application of the mechanism, the Commission must first build a strong case against the member state. Documents such as the annual Rule of Law report, the case law of the European Court of Justice (CJEU), the reports from the European Court of Auditors or complaints can all feed into the analysis.

The Commission must prove that:

- One or more principles of the rule law have been breached
- The breach occurred as a result of actions of public authorities of the member state in question
- The breach affects or poses a serious threat to the sound financial management of the EU budget or the protection of the EU's financial interests

Art. 2 of the regulation sets out criteria for defining the rule of law and Art. 3 provides a (non-exhaustive) list of the breaches. Once the Commission proves the link between the breach of the rule of law and the EU budget, it sends a formal letter of notification to the member state, which then has a right to make comments, provide information and offer possible solutions. Following the exchange of information, if the Commission considers the threat to the budget to persist, it can propose appropriate and proportionate measures to member states who have up to three months to debate and vote on the matter. The measures must be approved by the Council by qualified majority (55% of EU countries representing at least 65% of the Union's population). If the measures are approved, Art. 5 authorises the Commission to adopt measures that include suspending and reducing EU funds.

As highlighted in the guidelines, the member state is still required to provide EU funds to final recipients and beneficiaries. The measures taken can be lifted once the country rectifies the breach. If it partially remedies the situation, the measures can be adapted to reflect that.

How did we get here? Negotiations, reactions and next steps

The proposal for a regulation was first put forward by the Commission in May 2018 and dealt with in the European Parliament by two budgetary committees - the Budgets Committee (BUDG) and the Budgetary Control Committee (CONT). The proposal was perceived by many as a solution to the Council's inaction under Article 7 TEU proceedings (examined below), but member states that were already subject to other rule of law procedures criticised the new mechanism as another attack on their sovereignty. While the Parliament pressed for a broad application of the regulation, the Council called for a more limited approach.[1] The proposal was revived in 2020 when the EU was preparing its ground-breaking recovery instrument, the NextGenerationEU and the seven-year budget. The conditionality mechanism was designed to protect taxpayers' money from fraud and mismanagement, but despite the urgency in adopting

[1] The initial proposal was meant to target generalised deficiencies of the rule of law in member states, but as a result of the Council's opposition, the term was replaced with breaches and the requirement for a directly sufficient link was added.

the measures supporting the economic and social recovery, some member states opposed the text.

In November 2020, Hungary, Poland and Slovenia threatened to block the Covid economic recovery package because it included the conditionality regulation. On December 10, following an intervention from the German Presidency, a deal was struck in the European Council which allowed member states to challenge the rule of law mechanism at the CJEU and obliging the Commission to adopt guidelines on the application of the regulation following the CJEU ruling.[2] After adoption by the Parliament, the regulation came into force on January 1, 2021. Soon after that, Hungary and Poland brought a case before the CJEU on the legality of the regulation. The case was dismissed by the Court on February 16, 2022, and two weeks after the ruling was published, the Commission finalised and presented its guidelines.

The instrument has received widespread support among member states, especially Western governments[3] that do not want to be associated with countries that have been accused of disregarding the EU's fundamental values or corruption of Union funds. Some have been particularly vocal and even participated in the hearings before the CJEU,[4] showing their support for the mechanism. MEPs have been calling for the conditionality mechanism to be applied ever since it was approved and have criticised what they have argued are unjustified delays by the Commission, culminating in the lawsuit filed against the executive. According to the Parliament's interpretation, the Commission was bound by the regulation and not by the European Council's conclusions and therefore did not have to wait for the final judgment of the CJEU to trigger the mechanism.[5]

Even though most member states, and many academics, civil society groups and other stakeholders have welcomed the new instrument, some critics have argued that it was watered down following pressure from the Council and is now more of an anti-corruption instrument rather than a powerful tool to protect the rule of law. Many have noted there are practical difficulties in proving the causal link between the violation of the rule of law and the infringement of the EU budget.[6] The fact that the application can only be initiated by the Commission, which has been criticised for being slow to tackle rule of law issues, has only added to concerns about the use of the instrument.

In November 2021, the Commission sent letters to Hungary and Poland, inquiring about judicial independence and issues around fraud and corruption and stating that the responses from member states would feed into the Commission's assessment under the conditionality mechanism. On April 5, 2022, von der Leyen announced the Commission planned to trigger the

[2] Please see the European Council conclusions, December 10-11, 2020. The conclusions were criticised by a number of legal authorities as unlawful, see e.g. here and here.
[3] Please see the Benelux declaration from December 2021.
[4] The Netherlands, Germany, Belgium, Luxembourg, Denmark, Finland, Sweden, France, Denmark, Spain and Ireland defended the regulation during hearings.
[5] Please see the EP's resolution and a follow-up resolution.
[6] Please see here and here.

new conditionality mechanism for the first time against Hungary.[7] On April 27, the Commission sent a letter of official notification to Hungarian authorities that it had launched the sanction.

The move was welcomed by most political groups, although some said it was long overdue. Green MEP Daniel Freund, who negotiated the regulation on behalf of the Budgetary Control Committee, said: "*Finally after much floundering the Commission has decided to take action. While this step is of course welcome, it's way too late…We should not have to wait years for retroactive remedies to solve real time problems. The Commission is guardian of the treaties and must be proactive and consistent in working to safeguard the rule of law and democracy in the EU.*" During his speech in the Parliament's plenary on May 3, Justice Commissioner Didier Reynders said the member state has two months to submit its observations and propose remedial measures. Even though the attention is now on Hungary, he made it clear his team continues to monitor the situation in all member states and will take action when necessary.

Other measures in the rule of law toolbox

As examined above, the conditionality mechanism is a specific instrument - it can only be triggered if a direct link between a breach of the rule of law and EU taxpayers' money can be established. Nevertheless, the EU has other binding and non-binding measures which are designed to protect the rule of law.

The proceedings under Art. 7 TEU are arguably the strongest tool the EU has at its disposal to protect the rule of law and other fundamental values of the EU enshrined in Art. 2 TEU. They can be initiated by the Commission, the Parliament or one third of member states. Under Art. 7(1), the Council may determine a clear risk of a serious breach of EU values by a member state. Following the Parliament's consent, the Council issues a decision by a majority of 4/5 of the member states[8] and can also issue recommendations to the member state concerned.

Under Art. 7(2)-(3), sanctions can be triggered against the member state, if the European Council, after obtaining Parliament's consent, unanimously determines the existence of a serious and persistence breach of EU values. As a further step, the Council, through a qualified majority vote, can suspend certain rights of the member state, including its voting rights.

The procedure under Art. 7(1) has been triggered twice, in 2017 against Poland and in 2018 against Hungary. The two cases are still ongoing. Even though the hearings with the member states concerned resumed last year, no further steps have been taken. The fifth hearing on Poland took place on February 22 and the fourth hearing on Hungary is scheduled for May 23.

Among other measures, a preliminary procedure under Art. 267 TFEU allows domestic courts to ask questions to the CJEU relating to the interpretation of the EU law. The instrument aims to ensure uniform interpretation of the Union's legislation across its member states. The decision reached binds all member states and a failure to comply with an interpretation may lead to infringement proceedings.

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[7] Official reasons for not triggering the mechanism against Poland are unknown. The Commission reportedly decided to delay the procedure due to Russia's invasion against Ukraine and Poland's involvement in assisting refugees.

[8] The member state subject to the proceedings is not allowed to vote.

The Commission can launch an infringement procedure against a member state at the CJEU under Art. 258 TFEU, if the state fails to comply with its obligations under the EU treaties, including violations of the rule of law. The process starts with the Commission sending a letter of notification to the state concerned and giving it two months to reply. If the reply does not resolve the issue, the Commission can then present a reasoned opinion (a request to comply with EU law). If the country concerned does not comply with that request, the Commission can refer the matter to the CJEU. If the Court finds the state to be at fault and the state continues to refuse to comply with the measures prescribed, the Court can then impose a financial penalty.

In terms of non-binding measures, in 2014 the Commission set up a 'rule of law framework' to establish a structured dialogue with member states deemed to have rule of law deficiencies. The framework consists of three stages: assessment, recommendation and follow-up by the Commission. In the same year, the Council established its own annual dialogue between all member states on the rule of law which takes place at the General Affairs Council. The last dialogue took place on April 12, 2022, and concerned Luxembourg, Hungary, Malta, the Netherlands and Austria. Both frameworks were designed to find solutions through dialogue before resorting to legal mechanisms.

In 2020, the European Commission also started publishing an annual Rule of Law report, which records developments in all member states in four key areas: the justice system, the anti-corruption framework, media pluralism and other institutional issues related to checks and balances. The assessment is based on information provided by member states, as well as country visits and stakeholder consultations. The last report was published on July 20, 2021. Following criticism that the document lacked a dedicated follow-up procedure, the Commission decided to include recommendations in its future reports. The 2022 report is expected to be presented on July 13, 2022.