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## Going for the Wallet? Rule-of-Law Conditionality in the Next EU Multiannual Financial Framework

Article 2 of the Treaty on European Union (TEU) sets forth the founding values on which the EU is based, including respect for human rights, the rule of law and tolerance of minorities.<sup>1</sup> In recent years, numerous developments have made it increasingly questionable whether these values are still accepted by governments and electorates in all Member States. In Poland, after years of failed negotiations, the European Commission deemed in December 2017 that the country was at clear risk of seriously breaching the rule of law. Polish legislation is believed to be seriously damaging the independence of the Polish judiciary, including the Supreme Court, thereby abrogating the separation of powers. As a consequence, the Commission triggered an Article 7 procedure which, in the last escalation, could mean the suspension of the country's voting rights in the Council.

Similarly, the European Parliament sees a clear risk of a serious breach of the EU's founding values in Hungary after many years of failed attempts to moderate the government. As such, in September 2018, the Parliament requested that the Member States initiate an Article 7 procedure against Hungary due to concerns about the country's judicial independence, freedom of expression, corruption, the rights of minorities, and the circumstances faced by migrants and refugees.<sup>2</sup>

Despite the wealth of evidence that both countries have committed serious violations, the implementation of Article 7 sanctions is unlikely. To suspend voting rights, the vote within the European Council (excluding the accused Member State) must be unanimous.<sup>3</sup> Since two countries

have already been accused of Article 2 breaches and concerns about autocratic developments in other countries exist, a cartel between these governments could easily obstruct the full application of Article 7.

These developments crucially inform the intense debate that currently surrounds the possible introduction of a new type of conditionality in the next Multiannual Financial Framework (MFF). The basic idea underlying this new conditionality is to "hit offending nations in the wallet" by suspending EU funding. Indeed, the Member States in question are significant net recipients of EU money. Poland is by far the largest absolute recipient of EU transfers: Under the current MFF, the country receives 82 billion euros in cohesion spending and another 32 billion euros in agricultural payments. Overall, 15% of total funds that are allocated to all 28 Member States through Cohesion and the Common Agricultural Policy (CAP) go to Poland. Hungary is another major recipient of EU spending, receiving 23 billion euros in cohesion funding and 12 billion euros from the CAP.<sup>4</sup>

### The arguments against conditionality

The idea of financially sanctioning EU Member States has been advocated for some time and took shape concretely in May 2018. The European Commission presented a draft regulation to sanction Member States with "generalised deficiencies" in the rule of law, which was presented together with a comprehensive proposal for the next MFF. The proposed sanctions include the suspension of payments and EU-funded programmes.<sup>5</sup> This approach has been heavily contested and opposed not only by those governments under scrutiny. Within the Commission, President Jean-Claude Juncker appears unconvinced about his Commission's initiative, arguing that tying the rule of law to structural funds could be "poison for the continent and divide the European Union".<sup>6</sup> The underlying concern motivating this type of scepticism is that placing financial pressure on Member States could be

1 See Article 2 of the Treaty on European Union (TEU): "The Union is founded on the values of respect for human dignity, freedom, democracy, equality, the rule of law and respect for human rights, including the rights of persons belonging to minorities. These values are common to the Member States in a society in which pluralism, non-discrimination, tolerance, justice, solidarity and equality between women and men prevail."

2 G. Halmaj: The Possibility and Desirability of Economic Sanction: Rule of Law Conditionality Requirements Against Illiberal EU Member States, EUI Working Paper No. LAW 2018/06, European University Institute, 2018; European Parliament: Rule of law in Hungary: Parliament calls on the EU to act, Press Release, 12 September 2018.

3 Article 7 (2) of the Treaty on European Union (TEU).

4 European Commission: Preallocations MFF 2014-2020, available at [http://ec.europa.eu/budget/mff/preallocations/index\\_en.cfm](http://ec.europa.eu/budget/mff/preallocations/index_en.cfm).

5 European Commission: Proposal for a Regulation of the European Parliament and the Council on the Protection of the Union's Budget in Case of Generalised Deficiencies As Regards the Rule of Law in the Member States, COM(2018) 324 final, 2 May 2018.

6 F. Eder: Juncker: German plan to link funds and rules would be 'poison', Politico, 6 January 2017, available at [www.politico.eu/article/juncker-german-plan-to-link-funds-and-rules-would-be-poison/](http://www.politico.eu/article/juncker-german-plan-to-link-funds-and-rules-would-be-poison/).

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counterproductive, in part because it could whip up nationalistic and anti-EU sentiment as politicians and voters decry external intervention. As the poorer countries of the EU are concentrated in the east, such an instrument could aggravate the rift between new and old Member States in east and west respectively. Another frequently raised reason for opposing sanctions is that cohesion conditionality would negatively impact poor countries but do little to constrain richer countries.<sup>7</sup> Moreover, such sanctions are called into question because they do not directly impact the government, but rather the beneficiaries of EU programmes who are not responsible for government misbehaviour. A final argument is that the suspension of cohesion money would deter economic convergence, which is in the mutual interest of EU countries.

### The existing role of conditionality for EU membership, EMU and the budget

A few preliminary remarks concerning the role of conditionality in the EU in general and the budget in particular are important before the counterarguments are considered in larger detail. Conditionality is nothing new, but rather a defining element of the European integration and enlargement process. Indeed, various conditions are attached to achieving membership in both the EU and European Monetary Union (EMU). The Copenhagen criteria define the conditions a country has to fulfil before it can become a Member State. In addition to economic conditions, various political criteria must be met; the candidate country must prove the existence of reliable institutions that guarantee democracy, the rule of law, human rights and the protection of minorities. In the case of EMU membership, the well-known convergence criteria must be fulfilled. An analogous problem exists for both types of accession conditionality. Specifically, the incentives to fulfil conditionality are much higher prior to accession than afterwards.

There is evidence that the political conditions for accession have encouraged democratic developments as well as beneficial institutional arrangements prior to accession.<sup>8</sup> However, in the case of new Member States such as Poland and Hungary, we see a regression to weaker institutions after accession. A similar situation has arisen

in the context of EMU membership: conditionality that encouraged countries to consolidate their public finances had some measurable effects in the euro qualification phase, but fiscal restraint waned after the euro was introduced, culminating in the European debt crisis in 2010. Strategically, this pre/post asymmetry has the same underlying cause with regard to both EU and EMU membership: a credible threat of exclusion exists only in the pre-accession phase. This threat incentivises candidate countries to strive for the expected benefits of membership. There is no comparable threat post-accession as membership is permanent and there is no mechanism for the EU to expel a Member State against its will.<sup>9</sup> While Article 50 TEU does grant Member States the right to withdraw from the Union, no constitutional provisions exist to eject a Member State that does not comply with contractual obligations. To mitigate this pre/post accession asymmetry, there are different types of incentive schemes. A comprehensive set of fiscal and macro-economic rules with monetary fines has been established in the EMU. Similarly, the adoption of rule-of-law conditionality with cohesion-related monetary fines could incentivise compliance with EU values.

Conditionality is a defining feature of the enlargement process as well as of the EU budget. Whereas unconditional equalisation payments play a major role in existing federal countries, this type of payment is not found in the EU fiscal system. By design, all major EU spending programmes are conditional in the sense that they have specified objectives, a well-defined programming procedure and a comprehensive control system. These mechanisms aim to ensure that spending is consistent with the purpose of the programmes and in conformity with the legal and administrative dictates of sound financial management. Resources can be cut or suspended in the event of non-compliance, which has occurred in the past.<sup>10</sup> In this sense, the current debate is not about a new approach but rather about another kind of conditionality that will serve as a complement to the multiple conditions already attached to EU spending.

The idea of linking EU programmes to a condition that is not directly related to the spending programme itself is not fundamentally new. Since its establishment in 1994, the Cohesion Fund has allowed the Commission to suspend payments for countries that do not comply with the conditions of the Excessive Deficit Procedure. This principle has been expanded to apply to cohesion spending

7 A. Mattelaer (ed.): Exploring the Boundaries of Conditionality in the EU, Egmont European Policy Brief No. 51, Egmont Royal Institute for International Relations, June 2018; M. Kölling: Policy Conditionality – a New Instrument in the EU Budget Post-2020?, Sieps European Policy Analysis, Swedish Institute for European Policy Studies, November 2017.

8 F. Schimmelfennig, U. Sedelmeier: Governance by Conditionality: EU Rule Transfer to the Candidate Countries of Central and Eastern Europe, in: Journal of European Public Policy, Vol. 11, No. 4, 2004, pp. 661-679.

9 F. Heinemann: The Political Economy of EU Enlargement and the Treaty of Nice, in: European Journal of Political Economy, Vol. 19, No. 1, 2003, pp. 17-31.

10 J. Selih, I. Bond, C. DoJan: Can EU Funds Promote the Rule of Law in Europe?, Centre for European Reform, November 2017.

through “macroeconomic conditionality” in MFF 2014–2020. Specifically, this conditionality links structural funds to the different economic governance procedures. If a Member State does not comply with the prescriptions of the Excessive Deficit or the Excessive Imbalance Procedure, the Commission can trigger a suspension of payments. In addition, the current MFF has equipped cohesion spending with so-called “ex-ante conditionalities”. These are conditions that a Member State has to fulfil before it can receive cohesion money. Ex-ante conditionalities are of a general nature and require, for example, that country-specific recommendations under the European Semester need to be met at an early stage of programme implementation.<sup>11</sup> Thus, a new type of conditionality that hinges on respect for the rule of law would hardly constitute a revolution, but rather a further refinement to an existing system. Given this institutional backdrop, how valid are the counterarguments mentioned above?

### Will financial sanctions increase European polarisation?

*Conditionality as a driver of further polarisation:* The empirical literature offers mixed evidence concerning how international sanctions affect democratic development.<sup>12</sup> Indeed, far from encouraging better behaviour, the pressure of foreign sanctions often aggravates autocratic responses and the suppression of reform movements. Yet sanctions may also increase the likelihood of regime change, and, by extension, improve the outlook for democratic development. Moreover, financial sanctions can reduce the rents that an anti-democratic politician can promise to allies who are hostile to an existing democratic order. This could decrease the likelihood of an autocratic transition.<sup>13</sup> It might also be the case that the absence of sanctions, (the EU’s status quo) is not less polarising than a regime with strong value-related conditionality. Today, many voters and politicians in countries that are net contributors to the EU are vexed by the need to give substantial financial support to countries that violate fundamental EU values. Mounting frustration could undermine support for European integration and create hostility towards beneficiary countries. From this perspective, sanctions could help to restore procedural fairness and thus solidify acceptance for the European Union. In this way, there are various considerations that argue for and against the no-

tion that rule-of-law sanctions would aggravate or reduce polarisation.

### Would sanctions disproportionately impact poor countries and unintended target groups?

*Discrimination against poorer countries:* While it is true that the maximum possible financial sanctions that are linked to cohesion are higher for poor countries than they are for rich ones, wealthy Member States also receive substantial funding from structural funds: Germany, for example, has a cohesion allocation of 19 billion euros under the current MFF. This is the case because significant structural funding also flows to more developed regions. Thus, the suspension of cohesion funding can serve as a disciplinary tool against rich and poor countries alike. Another ideal candidate for an equal treatment sanction scheme is the Common Agricultural Policy (CAP). Since CAP is less digressive at higher levels of economic development, it provides even more substantial sanction potential for rich countries in the Union. Together, the curtailment of cohesion and CAP funding represents a viable basis for a non-discriminatory sanction system.

*Sanctions hit the wrong people:* A traditional argument against various types of sanctions is that they disproportionately affect citizens and regional jurisdictions that are not responsible for the misbehaviour of their national government. This argument is particularly valid when countries are governed by a dictatorial ruling clique that exploits and suppresses a disenfranchised populace. The current EU cases, which revolve around the lack of respect for a separation of powers, have a different character. The incumbent Polish and Hungarian governments have mandates from voters with comfortable majorities in elections that were judged to be free and fair. In this sense, the policies of the Polish and Hungarian governments against the independence of the judiciary have the backing of the electorate who voted for these policy platforms. In addition, the EU cohesion and agricultural spending targeted under new conditionality rules is concentrated in the poorer, more rural regions of these countries. These are precisely the regions in which the elected parties saw the greatest voter support. A similar consideration applies to CAP: Farmers, who are the main sectoral beneficiaries of EU spending, are generally part of the milieu that strongly support the reigning parties in both countries.<sup>14</sup> It goes without saying that sanctions are a form of collective punishment that will invariably impact numerous individual voters who are strongly opposed to

11 European Commission: Fact Sheet: The Future of EU Finances: The 7th Report on Economic, Social and Territorial Cohesion, Brussels, 9 October 2018.

12 C. von Soest, M. Wahmann: Are Democratic Sanctions Really Counterproductive?, in: Democratization, Vol. 22, No. 6, 2015, pp. 957–980.

13 T. Apolte: A Theory of Autocratic Transitions. Prerequisites to Self-Enforcing Democracy, Paper presented at the Annual Conference of the Verein für Socialpolitik, Freiburg, September 2018.

14 P.S. Swallow: Explaining the Rise of Populism in Poland: The Post-Communist Transition as a Critical Juncture and Origin of Political Decay in Poland, in: Inquiries, Vol. 10, No. 7, 2018.

the incumbent government. This is the basis for an approach that shields individual recipients of EU money from losses, as proposed by the European Commission (see below). However, the introduction of cohesion and CAP conditionality to the current political setting would not specifically impact groups that bear no responsibility for their country's current illiberal course. On the contrary, the empirical evidence suggests that these sanctions would be fairly well targeted.

### Would the suspension of cohesion payments damage economic convergence?

*Sanctions damage the process of economic convergence:* Critics of the new conditionality point out that cohesion policies aim to support economic convergence between regions and promote support for European integration. They warn that sanctions that suspend cohesion payments interrupt ongoing investment projects and worsen the prospects for economic and social cohesion, resulting in detrimental effects for the integration process. An important response to this criticism is that it would not apply to CAP. Direct payments to European farmers do not contribute to the generation of European added value, but rather are the product of path dependencies and lobby power.<sup>15</sup> Therefore, the suspension of CAP direct payments in sanctioned countries would hardly contravene long term European development goals.

The aforementioned criticism is also without merit in reference to cohesion spending. The argument against conditionality is only valid if one presupposes that cohesion spending is actually an effective tool for promoting growth and regional convergence. The empirical evidence that EU cohesion spending actually promotes convergence is not clear cut, however. Surveys of the vast empirical literature offer diverse findings indicating that cohesion spending may exert positive growth effects, no growth effects or even negative growth effects.<sup>16</sup> Indeed, a cursory glance at the past is sobering: Greece has been the recipient of very significant cohesion transfers in recent decades, but these transfers failed to trigger a lasting convergence process – a fact that became particularly evident with the outbreak of the crisis in 2010. Accordingly, it is not clear whether cohesion transfers promote growth or should in-

stead be understood as largesse that potentially serves other purposes. If structural funds are merely a transfer system in disguise, then they are an excellent candidate for the application of pecuniary fines.

A further essential finding is that the growth effect of cohesion spending depends to a large extent on the quality of institutions. Cohesion payments can only be expected to serve their purpose if they are accompanied by an effective public administration, public employee selection and promotion based on competency rather than cronyism, independent courts and judges, as well as the effective containment of corruption. Weak institutions will also deter private investment due to a lack of legal protection of property rights. Therefore, there is a fundamental and compelling argument in favour of rule-of-law conditionality that relates to the objective of cohesion policy itself. Non-compliance with the rule of law reduces the chances that cohesion policies can achieve their objective. Countries like Poland and Hungary that currently align their courts with the interests of their ruling parties pave the way for even more corruption and cronyism. The continuation of cohesion payments in the face of such institutional deterioration is likely to result in wasted EU spending. Accordingly, it is virtually impossible to support the long-term objectives of cohesion policy without recognising the justification for strong and effective rule-of-law conditionality.

### Recommendations

The following recommendations should guide the further elaboration of conditionality provisions:

First, rule-of-law conditionality should be extended from cohesion spending to agricultural transfers. CAP payments to rich Member States are much higher than cohesion allocations and thus offer a basis for a sanction threat that can incentivise both poorer and richer countries.

Second, EU conditionality provisions should try to shield the individual recipients of EU transfers (e.g. farmers or regions) from the direct consequences of a funding suspension by shifting the burden to national budgets. The Commission draft of the rule-of-law regulation points in the right direction, as it seeks to protect individual beneficiaries of EU funding, such as Erasmus students, researchers and civil society organisations. The draft regulation states that a suspension of EU payments shall not affect a government's obligation to implement programmes. This implies that while the national co-financing share may rise, the programme would be required to continue without cuts. This approach could be generalised and also expanded to include other actors and entities, e.g. farmers

15 The European Court of Auditors has shown that the "greening" conditions attached to CAP payments that are directly allocated to farmers are largely ineffective. These conditions aim to incentivise environmentally friendly production. See F. Heinemann, S. Weiss: *The EU Budget and Common Agricultural Policy Beyond 2020: Seven More Years of Money for Nothing?*, Reflection Paper No. 3, Bertelsmann-Stiftung, 2018.

16 F. Heinemann, T. Hagen, P. Mohl, S. Osterloh, M.O. Sellenthin: *Die Zukunft der EU-Strukturpolitik*, ZEW Wirtschaftsanalysen, Vol. 94, Baden-Baden 2010, Nomos.

(CAP) and regions (cohesion), thus placing the full weight of cuts on the central budget.

Third, a less politicised institution than the European Commission should be endowed with powers to trigger a procedure if certain criteria are fulfilled. The European Commission has a notoriously poor performance in applying conditionality both to the Cohesion Fund and the Stability and Growth Pact. Similarly to fiscal conditionality,<sup>17</sup> a less politicised and more neutral institution than the Commission would be highly desirable as the arbiter of rule-of-law conditionality.

Fourth, the debate surrounding migration policies and the reception of refugees should not be confounded with the rule-of-law crisis in some of the new Member States. The arguments in favour of rule-of-law conditionality are not directly related to the ongoing EU controversy on refugee

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17 Z. Asatryan, F. Heinemann: The European Fiscal Board: An Experiment at the Supranational Level, in: R. Beetsma, X. Debrun (eds.): *Independent Fiscal Councils: Watchdogs or Lapdogs?*, London 2018, CEPR Press, pp. 165-173.

reception. Carrots rather than sticks could be used as an incentive mechanism when it comes to dealing with refugees: Countries that contribute to the European public good of refugee reception could be rewarded by the EU budget.<sup>18</sup>

Summing up, the case for rule-of-law conditionality in EU spending is compelling even if one limits the argument to a very narrow perspective that focuses only on the convergence objective of cohesion policy itself. EU funds that promote economic convergence will hardly reach their objective in countries sliding toward a system that lacks effective checks and balances. Cohesion payments to countries with deteriorating institutions do not promise to generate further convergence; therefore, conditionality is not only justified, but perhaps also inevitable. Accordingly, the Commission proposal for a new generalised rule-of-law conditionality deserves strong support.

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18 M. Berger, F. Heinemann: *Why and How There Should Be More Europe in Asylum Policies*, ZEW Policy Brief No. 16-01, Centre for European Economic Research (ZEW), 2016.