NEW EU SANCTIONS MECHANISM COULD SEE MEMBER STATES LOSE EU FUNDING

Implications of the introduction of the EU's rule-of-law conditionality mechanism

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Issues & Sectors	EU Recovery Funding, EU Budget 2021-2027
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In a long-awaited ruling on February 16th, the Court of Justice of the EU, the highest court of the European bloc, ruled that the EU's much-debated rule-of-law conditionality mechanism (a new sanctions instrument that would link the disbursement of EU funds to upholding democracy and the rule of law) was compatible with EU law. The much-anticipated decision is a major blow to the Polish and Hungarian governments that challenged the regulation in court in 2021.

Both CEE governments have been locked in a long-running dispute with EU institutions over alleged democratic backsliding, signalling that Budapest and Warsaw, both of which are major beneficiaries of EU funding, could be the first targets of the new sanctions mechanism that could ultimately lead to the loss of funds from Brussels. This comes as Poland and Hungary are yet to secure billions of euros of post-pandemic recovery funding from Brussels to support their economic recovery in the wake of the COVID-19 crisis.

Below, Aretera provides a brief overview of the landmark court decision, its implications for Central and Eastern European markets, as well as possible future scenarios.

This memo will cover:

A Landmark Ruling

On February 16th, the Court of Justice of the European Union (CJEU) issued a much-anticipated ruling on the European Union's rule-of-law conditionality mechanism, a new sanctions instrument that would allow EU institutions to suspend or even reduce funds distributed to member states under the Multiannual Financial Framework (MFF), the EU's seven-year budget. In its long-awaited ruling, which comes after the Hungarian and Polish governments challenged the legality of the instrument, the CJEU found that the conditionality mechanism, which would essentially tie the distribution of EU funds to upholding European values, was indeed compatible with EU law and the bloc's founding treaties. The CJEU ruling is the latest culmination of Brussels' years-long battle with Hungary and Poland, both of which have been locked in a long-running dispute with EU institutions over alleged democratic backsliding.

- The European Council, the EU's top political decision-making body, which consists of EU heads of state and government, endorsed the conditionality mechanism in late 2020. At the time, Warsaw and Budapest, however, initially threatened to veto the adoption of the EU's seven-year budget for 2021-2027 and the European bloc's landmark post-pandemic recovery package, the Next Generation EU (NGEU) program worth €750 billion in loans and grants, if the rule-of-law instrument was approved.
- Under a political deal between the two Central European governments and the rest of the EU's leaders, Poland and Hungary refrained from vetoing the funding packages in exchange for the chance to challenge the proposed sanctions in the Court of Justice. Consequently, both funding packages were adopted and later introduced, while the two CEE governments issued a legal challenge against the mechanism in 2021, arguing it was incompatible with the bloc's founding treaties.
- Relations between the two CEE governments and Brussels became even more tense after the European Commission refused to endorse the Polish and Hungarian National Recovery and Resilience Plans (NRRPs), needed to unlock crucial post-pandemic recovery funding approved in late 2020. Under the Next Generation EU program , Poland is entitled to more than €36 billion in funds and loans, while Hungary could receive more than €7.2 billion in non-refundable recovery funding. The Commission has continued to block recovery funding from both member states, criticizing the lack of action against mass corruption in Hungary and the abuse of the rule of law in Poland.
- The EU's bilateral ties with Poland also reached a new low during the second half of 2021 after the Polish Constitutional Tribunal (PCT) essentially questioned the primacy of EU law over national law in an October ruling. Shortly afterwards, the EU's highest court imposed a record-breaking €1 million daily fine on Warsaw for not suspending a judicial disciplinary body under the country's much-criticized judicial reforms. Brussels replied by launching legal actions over the aforementioned Polish ruling early this year, increasing tension between the two sides.
- In early December, the Advocate General of the CJEU advised that the mechanism is indeed compatible with EU law, foreshadowing the final verdict as most EU court rulings follow the legal opinion advised by the Advocate General. This was followed by official warnings from the European Commission to the Polish and Hungarian governments, signalling that the EU's top executive body stands ready to introduce the new sanctions mechanism once it is approved by the CJEU.
- Both CEE governments were quick to criticize the CJEU ruling in the case, claiming bias and hidden political motivation. The Polish Government accused the EU of attempting to

reach beyond its founding treaties, while the Hungarian Government said that Brussels' rejection of the country's controversial LGBT+ legislation stood behind the decision of the court verdict. This law was adopted last summer but will be subject to a national referendum to be held on the same day as the upcoming parliamentary elections in April.

Implications For CEE Markets

With the CJEU ruling giving the greenlight to the EU's top executive body to sanction member states which it finds in abuse of the rule of law, the European Commission has been granted the most influential instrument so far against member state governments. The Commission has indicated a number of times that it will use the new sanctions mechanism once the CJEU approves it, however the corresponding regulation greenlighted by the CJEU includes a lengthy process before sanctions can be introduced.

The CJEU decision bears high importance for both Hungary and Poland, the two countries that have challenged the corresponding EU regulation. Both CEE governments heavily rely on MFF funding: Hungary receives more than €30 billion under the MFF, while Poland has been one of the largest beneficiaries of EU funding since the country joined the European bloc in 2004, with Warsaw's share from the EU's seven-year budget amounting to more than €135 billion. Both countries are also yet to secure post-pandemic recovery funding from Brussels.

As the Polish and Hungarian governments continue to be embroiled in political disputes with the EU institutions, below we outline the implications of the landmark court decision.

- **Hungary and Poland could be the first to be targeted.** Brussels has been locked in a long-running dispute with Poland's ruling Law and Justice party and Hungary's governing Fidesz party for years. In 2018, both the Polish and Hungarian governments were targeted by the EU's so-called Article 7 procedure, a formal review of the situation of the rule of law and democracy aimed to address the alleged shortcomings in both countries. However, the procedure, which could theoretically lead to suspending the voting rights of the member states under review, is still ongoing. With the procedure stalling, the European Commission has been facing heavy political pressure from the net contributors of the EU's seven-year budget and the European Parliament to sanction countries over alleged wrongdoings. Taking the disputes of the past years into account, Warsaw and Budapest are natural targets for the European Commission. Other Central and Eastern European countries with a history of conflict with EU institutions, including Romania, Bulgaria and Slovenia, could also be targeted, however this is unlikely to happen in the short term.
- **There is a long way to go until funds are actually suspended.** Despite the clear intention from the European Commission to use the instrument, it remains currently unclear when that might happen and whether both Poland and Hungary will be targeted. Prior to the CJEU's decision, the European Commission signalled that no funds would be withdrawn from Hungary before the upcoming parliamentary elections on April 3rd. At the same time, this does not exclude the possibility of starting the procedure before the April vote, as it will take an estimated 6-9 months before the suspension of funds reaches a decision point. (The Commission is currently assessing the court decision and is due to make a corresponding announcement in the coming weeks.)
- Under the conditionality regulation, the European Commission – following a thorough exchange of views on disputed matters with the member state in question – can initiate a

"proportionate" suspension or withdrawal of funds, however the final decision lies with a qualified majority within the Council of the European Union, which incorporates all member state governments. The procedure also includes the possibility of a potential settlement before sanctions might be adopted. Furthermore, the disputed member state can ask for an additional review from the European Council (heads of state and government) if it disagrees with the findings of the procedure. Finally, the amount of EU money subject to potential suspension remains unclarified in the CJEU-approved regulation, leaving the sum of potential losses wide open and dependent on the decision made in the Council of the EU.

- **The fate of EU recovery funding for Poland and Hungary also remains unknown.** On top of the possibility of losing funds under the EU's seven-year budget (MFF), the European Commission has continued blocking post-pandemic recovery funding for both Poland and Hungary, due to ongoing disputes over the situation of the rule of law in Poland and alleged institutional corruption in Hungary. In the wake of their efforts to continue their post-pandemic economic recovery, both funding opportunities are crucial for the two CEE countries. While the Commission is yet to decide whether it will trigger its newly greenlighted sanctions instrument against Warsaw and Budapest, recovery funds for Poland and Hungary also hang in the balance.
  - If Hungary's ruling Fidesz party wins the upcoming parliamentary elections, which is the most likely scenario[1] for the April electoral contest, the European Commission will remain more likely to pursue the sanctions mechanism as it will face heavy political pressure to do so from other EU institutions. At the same time, the Hungarian Government will likely aim for a settlement with Brussels, particularly in the case of the NGEU funds should Prime Minister Viktor Orbán remain in power. Under the scenario of Hungary's united multi-party opposition winning the April vote, the future unlocking of recovery funds remains more likely.
  - Despite its initial rejection of EU demands concerning the rule of law, the Polish Government of Prime Minister Mateusz Morawiecki is now also aiming to unlock recovery funds and keep the disbursement of MFF funding by reversing some of the controversial judicial reforms. However, the Morawiecki Government, supported by the four-party United Right coalition, has so far been unable to do so since United Poland, a minor member of the ruling coalition whose leader, Justice Minister Zbigniew Ziobro, was the key figure behind the judicial reforms, has continued with the reforms. The CJEU ruling over the conditionality mechanism will likely further increase tension between the major ruling Law and Justice party (PiS) and United Poland, increasing the possibility of another major coalition dispute or break-up. At the same time, Ziobro, reacting to the CJEU ruling, said the Polish government "might initiate some changes" to the country's judicial laws, leaving the possibility of a future settlement open, as well.
  - While both countries aim to unlock recovery funding and prevent the loss MFF funds, the Polish and Hungarian governments also seem to be preparing for a lengthy battle with Brussels concerning the future of EU funds. A day after the CJEU ruling, Hungary's state debt management agency and the Polish treasury signed a framework agreement about mutual liquidity support. While the bilateral agreement primarily applies to one country supporting the other if the latter faces difficulties in selling bonds on financial markets, it could also indicate preparations by the Polish and Hungarian governments for scenarios involving the lack of NGEU funds going forward.

Conclusions

By rejecting the Polish-Hungarian legal challenge against linking the disbursement of EU funds to upholding European values, the Court of Justice of the European Union has granted the European Commission its most influential sanctions mechanism against the EU's own member states. The Commission is facing heavy political pressure to launch the mechanism but whether it will do so will only be seen in the coming period.

The conditionality mechanism will allow the EU's top executive body to initiate procedures against any member state believed to be involved in the abuse of the rule of law, which could result in the loss of EU funds for member states. However, the new mechanism entails a lengthy process and there are a number of contributing factors before EU funds could actually be withdrawn. Most crucially, the mechanism does not specify the amount of loss for member states governments, leaving the eventual sanctions subject to decisions made at the Council of the EU.

Given their long-running disputes with the EU institutions over alleged democratic backsliding and institutional corruption, the Polish and Hungarian governments are the most likely to be targeted by the European Commission in the short term, while other CEE countries, including Romania, Bulgaria and Slovenia, could also be targeted. Domestic politics will be a major factor in whether Budapest and Warsaw could see the loss of EU funds under the bloc's seven-year budget, particularly in Hungary due to the country's upcoming parliamentary elections.

Besides facing the loss of EU funds under the bloc's seven-year budget, Budapest and Warsaw are yet to secure billions of euros in recovery funding, which they hope to unlock in the near future to support their countries' economic recovery. Nonetheless, the possibility of a future settlement with Brussels remains unclear due to coalition disputes over the issue in Poland and the upcoming April vote in Hungary, meaning the upcoming months will be crucial in terms of what can be expected next.

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If you would like to schedule a discussion of this paper, please contact:
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