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EU RECOVERY FUND: BEYOND THE VETO

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In this contribution, we look at feasible alternatives to ensure that the European Union can deal with the post-pandemic recovery should Poland and Hungary maintain their veto on the Multiannual Financial Framework.

A shorter version of this piece has appeared on the German constitutional law website Verfassungsblog.

Background

The issue of Rule of Law (RoL) conditionality for the disbursement of funds has been prominent in the negotiations leading to the deal on the EUR 750bn Next Generation EU package, pushed in particular by the Netherlands and the rest of the 'frugal' team. Yet, the Council conclusions in July only included a very weak mention of the issue – signalling that it was not possible to strike a balance at the level of heads of state and government and Council was kicking the can down the EP's road.

On November 10th, the EP and the German Presidency reached a compromise agreement on the text of a Regulation that would establish a RoL conditionality mechanism for the budget. This is not a blanket tool, as it would only allow funds to be suspended for EU governments engaging in RoL breaches *that directly affect the budget or seriously risk doing so.* Proponents basically hoped the Commission could be creative in finding ways to assess this risk, so that this tool could become a way to enforce Article 7 TFEU (which applies to general RoL violations) from the backdoor. Opponents (Hungary and Poland) feared the ambiguity for the same reason.

The new conditionality mechanism is set out in a Regulation, which only requires a qualified majority to get approved. After the agreement, the Hungarian and Polish PMs sent official letters to the European Commission President criticising the RoL mechanism and threatening a veto to the EU budget which, unlike the RoL Regulation, requires unanimity to be approved.

The Regulation was approved at qualified majority in the Permanent Representatives Committee (COREPER) 3 days ago, and as such it could be approved without no further discussion in the first useful Council meeting. In the same COREPER meeting, however, Poland and Hungary vetoed the Own Resources Decision (ORD) – which is a key document for the Recovery Fund (RRF) to happen. The ORD in fact sets out the maximum level of resources the EU budget can draw from the Member States, and increasing that limit is required for the EU to issue the EUR750bn under Next Generation.

The final decision likely will not be taken before the December 8th Council, result, discussions the General Affairs Council, convened on Tuesday, remained effectively stuck on both the RoL mechanism and the ORD (which requires unanimity to be approved).

What should the EU do?

Following the veto, there have been rumours about the possible introduction of 'reassuring' language in the RoL Regulation. We think that anything that could be read as a backtracking on the principle contained in the RoL mechanism would inflict a serious blow to the credibility of the whole rule of law discussion and allow two wannabe authoritarian regimes to score an easy win on a matter of fundamental values. With so much political capital having been spent already on linking the approval of the RoL Regulation to the Budget negotiation – which was a deliberate political choice, in no way automatic – the EU should not weaken the language in the Regulation. Moreover, any change in that direction would very likely alienate the EP and the self-labelled 'frugal countries', who have been among the most vocal on demanding strict RoL conditionality and whose se vote is as essential as that of Hungary and Poland to pass the ORD. The issue is unlikely to go away with a simple re-wording, and it will necessitate a serious confrontation at the highest political level to be resolved. Hence, the key question in our view is whether the veto is credible, and under what conditions.

Is the veto credible?

Yes and No. This is a game where sequencing is key. Let's work it backwards.

If Hungary and Poland really were to hold their veto on the ORD, then the new MFF would not be approved by end-2020. Article 312(4) TFEU states that in such case the 2020 yearly budget (which is dependent on the 2014 MMF and therefore does not include the RRF) would be rolled over to 2021. Poland and Hungary are typically net recipients from the MFF (although their net positions could end up being reduced, in the 2021-27 cycle). By blocking the ORD, they clearly would be forfeiting the share of RRF money to which they are entitled, but they would still get more out of the rolled over budget than most Western EU countries. How much money will ultimately depend on whether the programmes within the MFF whose legal basis expire at the end of the year will be renewed. As some have highlighted, the European Parliament has long pushed for a decoupling of spending programmes from the MFF, to preserve the flow of funds – although under the old ceilings – in case there was no deal in the Council on the new MFF. Politically, this seems unlikely at this juncture – although trialogues on the individual programmes are still ongoing despite the blockade. Even if, as it seems likely, the renewal of these programmes were to be blocked at the Council level, Hungary and Poland would still be getting direct payments to farmers, as the legal acts for the first pillar of the Common Agricultural Policy (CAP) do not include a limitation on their duration. Of course, Hungary and Poland will eventually need a deal on a *new* budget, but what we want to highlight here is that in a roll-over scenario they are in a relatively better condition than countries like Spain (who is a small net recipient under the regular EU budget) or even more so Italy (who would be a net contributor) – for which it is the RRF that really makes a difference. The governments of Hungary and Poland clearly know this, and are using the veto in the hope to force these countries' hand on the RoL Regulation: while they would still be financially worse-off in case of failure to reach an agreement, their "fall-back" position is better than the position of Italy or Spain.

So, the next logical question is: what does it take for the veto to become untenable? We think it takes the combination of two things: (i) final approval of the RoL Regulation and (ii) a credible threat of a Plan B on the RRF. The first condition alters the sequence of the game: once the RoL Regulation is approved, it will apply to *all* EU spending, including any new Budget as well as the emergency Budget carried over in case of no agreement. The 'regular' EU money that Hungary and Poland receive, will be all subject to RoL scrutiny. This alone would not be enough of an incentive to drop the veto, however: European integration is a "repeated" game, and therefore it may make sense to accept short term costs if this leads to change in behaviour in other parties, which pay out in the long term. In this perspective, it might be that once the RoL Regulation is approved, Hungary and Poland could nonetheless hold the veto so to extract future changes to the RoL regulation or guarantees on its application, accepting the costs that uncooperative behaviour entails in the short term, to change the long-term incentives of other European countries. Even more importantly, there might be public opinion benefits in blocking the RRF- which could boost the standing of the Hungarian and Polich governments with part of the domestic constituency, if it were to be presented as a retaliation against rule of law. To take away these incentives, the rest of the EU needs in our view to show that there is a credible Plan B for the RRF, feasible without the vote of Hungary and Poland. At that point, Hungary and Poland would have failed to block the RRF for the other countries, would not get any RRF money themselves, all while still getting the RoL scrutiny on a much smaller amount of money. There would be no incentive to hold the veto any longer.

So, what is Plan B?

We think there are three options: (1) enhanced cooperation; (2) a variable Euro/non-Euro setting, and (3) an intergovernmental solution. All of these options have problems, and they are clearly inferior to the original plan of having the RRF as part of the EU budget. Yet, they could work as credible plan B.

Enhanced Cooperation: A qualified majority of countries could trigger enhanced cooperation, i.e. a procedure that allows a smaller group of countries (9 at least) to move closer in the integration process insofar this does not endanger the rights of the remaining countries. This has been used in the past for several initiatives, for instance the establishment of a European Public Prosecutor, of the European Patent Scheme, and for the Financial Transaction Tax (FTT). The group could establish the grant element of the RRF by and on behalf of only those states which participate. The Council authorizes by qualified majority the initiative, meaning that Hungary and Poland do not muster a blocking minority. A potential roadblock at this stage would be for Poland and Hungary to argue that, by establishing a major MFF-related instrument by means of enhanced cooperation, the participating countries would be violating their rights as equal members of the Union, entitled to have a veto power on budgetary matters. This however seems hardly tenable from a legal perspective, since any such enhanced cooperation would be the result of the very exercise of these rights (in form of a veto). However unlikely the argument is to succeed in court, we believe this would be the primary legal roadblock against the use of enhanced cooperation. Once the authorization is passed by the Council, the participating countries can go forward and establish (by unanimity among them) a special framework for cooperation. Within this framework, the core group would be free to choose to act by qualified majority on the governance of the tool. We believe that this is essential and needs to be introduced from the beginning, since the treaty explicitly states that once the mechanism is established, the participating countries cannot exclude the remaining countries from joining. Since Poland and Hungary cannot be excluded from joining, the mechanism must involve majority voting since the beginning, or otherwise it will be subject to the same problems that we are currently trying to solve. At any rate, if the RRF were to be established through enhanced cooperation, the participating countries would need to pay for it themselves, by agreeing an ORD limited only to the participants. In a way, this creates a two-tier budget: a broad budget tier, amended by unanimity, including Hungary and Poland but no RRF, and an additional inner tier, amended by majority voting, that would be finance by all countries (excluding Hungary and Poland) to fund the RRF. Notably, the EC could still issue bonds on behalf of only the Member States participating in the enhanced cooperation: the repayment of such issuance would come from the Own Resources Decision relating to what we called the 'inner budget', rather than from the regular ORD covering the broad budget.

Special Framework for Euro countries. The special provisions for Eurozone countries may also offer an alternative for the construction of a dedicated RRF. The legal basis would be akin the one previously identified for the Eurozone "fiscal capacity" (the now-defunct Budgetary Instrument for Convergence and Competitiveness - BICC): namely, the joint effect of art. 175 (3) and art. 136, the former allowing for actions beyond the structural funds, and the latter allowing for enhanced coordination of the economic policy of the Euro Area members. The main advantage of framing the instrument in terms of Euro Area stability is that Hungary and Poland become natural outsiders, and the treaty itself provides the ground for exclusion from the governance mechanisms. As the recent position taken by Slovenia illustrates, however, limiting the perimeter to the Eurozone would not in and of itself shield the RRF from a veto – unless the Eurogroup were to decide to abandon its custom to decide by consensus. Conversely and by the same token, other non-Euro Area countries who might want to benefit from the Euro-RRF (such as Bulgaria, Romania, Czechia and Croatia) would find themselves in the odd position of being equally excluded. A workaround to this limitation would be to complement the instrument with provisions grounded in art. 143, whereby assistance may be provided to countries with a temporary derogation from Eurozone membership. While this would not allow for the exclusion of Poland and Hungary, it would nonetheless defuse their veto on the RRF. However, the legal basis for autonomous Eurozone action, especially when it comes to appropriations, is more blurred than in the case of the establishment of enhanced cooperation; we therefore consider the Euro Area solution a possibility, but overall inferior to enhanced cooperation, since it would entail higher legal risks and a much more complex set-up.

***Ad hoc* Intergovernmental Treaty:** An extreme alternative would be for the rest of the EU to take the RRF out of the EU budget and replicate it into an ad hoc intergovernmental agreement (like the one that gave birth to the ESM). This option would entail two types of complications. On the governance side, previous experiences with the intergovernmental setting – especially the ESM – have been skewed towards unanimous decision-making, including by requiring the involvement of the German Bundestag on decisions of a financial nature. A counterargument to this concern, is that the intergovernmental agreement could carbon copy the July Council agreement in terms of the governance mechanism – including with regard to the role of the European Commission in the assessment of recovery plans and the role of the Council (in this case, limited to the parties to the intergovernmental agreement) in endorsing both that assessment and the disbursement. The use of an intergovernmental treaty does not prevent automatically the attribution of functions to existing Union bodies: for instance, art. 5 of the ESM treaty explicitly provides for linkages between Union bodies and the ESM; articles 5 and 8 of the TSCG even provide for a limited set of new responsibilities bestowed upon the Commission, the Council, and the Court of Justice. Hence, there is no reason why an intergovernmental treaty should not be able to bestow on a specific configuration of the Council certain competences. Hence, assuming that the Council July agreement was concluded by all signatories in good faith, there would be in principle no reason to change the governance so as to require unanimity – particularly because the July agreement already includes a safeguards in the form of the 'emergency brake'. Replicating the governance structure already agreed upon in July could also help on the second problematic aspect of de-linking the RRF from the EU budget – i.e. the need to set up some form of special purpose vehicle that would issue the bonds needed to fund the RRF, given that this task could no longer fall on the EU once the RRF is taken out of the Community framework. In the past – notably in the case of the EFSF – Eurostat had concluded the debt issued by an SPV should be re-routed back onto the member states' public debt, which would obviously take away the key benefit of having half of the RRF in the form od grants. However, one key argument in the Eurostat EFSF decision was that the EFSF acted "exclusively on behalf of [the members of the Euro area] and under their total control", it only reported on its activities to the Eurogroup (recognized in the Treaty of Lisbon as just a working group of the Council) and was "not under the control of existing European institutions". this problem would be mitigated by adopting a governance structure – like the one agreed upon in July – in which the European Commission and the Council have a clear role and say on the RRF – although none of this would solve the fact that taking the RRF outside of the Community framework would also deprive the European Parliament of scrutiny rights. These scrutiny rights were implicit and automatic insofar the RRF was part of the broader MFF process; simply replicating the narrow RRF agreement, without taking care of the broader setup it was immerged into, would leave the Parliament out, hence possibly leading to problems of democratic legitimacy. However, providing a role for EP scrutiny is a very minor *formal* change to the agreement, which leaves the *substance* unchanged, for the EP scrutiny is there automatically when the RRF is part of the MFF. Hence we see no fundamental issue in attributing to the Parliament scrutiny powers. Finally, some argue that Constitutional barriers exist (especially in Germany) to the construction of budgetary instruments outside the MFF. Most of these arguments rely on a literal reading of the 2013 ESM decision delivered by the Bundesverfassungsgericht. However, the issues raised by the Court in the 2013 judgement are not mere formalistic barriers, but pertain the fundamental relationship between democratic oversight, the rights of German citizens, and public spending. Without discussing the details of the choices (in terms of legal and political philosophy) made by the Court with regard to the relationship between representation, identity and spending capabilities, we believe that these are substantive issues and not merely formalistic ones. Hence, replicating the *substance* of the agreement as discussed above (inclusive of the rights of oversight bestowed upon the European Parliament) should not change the assessment. If the RRF were to be judged as consistent with the Basic Law when part of the MFF, then an identical degree of democratic oversight under a different legal basis should not alter it; after all, the Union was based on a plurality of Treaties not so long ago. Whether an instrument like the RRF is consistent *as such* with the Basic Law is a different matter: we believe it would be, since it does not produce potentially unlimited liabilities for the German citizens and it does remain under control of the Council and of the Parliament throughout the process. In particular, and differently from the ESM, replicating the Council July agreement would mean that the intergovernmental RRF would be capped in size and repayment would be determined according to countries shares in the EU budget (adjusted as to reflect the group of participants). But if the RRF were it to be found not compatible with the Basic Law —assuming the substantial equivalence discussed above— that would be then be true even under the MFF. Hence, we maintain that switching from a Community governance grounded in the TFEU, to an identical community governance based on a new legal basis, would not alter the *substantive* appraisal regarding the constitutionality of RRF one way or the other.

Conclusions

We think that the EU is currently facing a historic cliff moment: the biggest step towards closer economic integration to date (the Next Generation EU package and most notably the RRF within it) is clashing with and risks being nullified by the most severe centripetal tensions on the equally vital issue of rule of law and fundamental values. The EU should not compromise on the Rule of Law Regulation and, as shown above, holding the ground on the ROL is one of two necessary elements needed to call Hungary's and Poland's bluff. The second necessary element is the threat of a credible outside option for the RRF. Hence, we think it is time to start considering plan Bs. We have discussed three such plans, all of which we deem sub-optimal to the original plan of having the RRF as part of the EU budget but that would allow the EU to show that the commitment to the advancement of economic integration is serious enough for leaders to withstand blackmailing even if this requires going down a more complex route. We are aware that this is a risky territory, but the stakes are high enough.

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