

# The Rule of Law in Times of Financial Crises

## How EU Rule of Law Correlates with the Market

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## 1 Introduction

Systems have been established for measuring and sanctioning rule of law-related developments for their own sake, while other systems exist for measuring similar developments for their impact on financial stability and potential political risk. These systems are entirely different, as are their strengths. While the outcome of the former will find its way into the ministries of justice and interior for consideration, the latter will become the preoccupation of ministries of finance and offices of prime ministers.

For those who regard the rule of law as a principle pertaining only to the justice system – perhaps even more specifically: the criminal justice system – the financial crisis would appear to have little bearing on the rule of law. For those, on the other hand, who see the rule of law as a constitutional principle with implications for all three branches of government at every level, the regulatory mechanisms that functioned or malfunctioned during the crisis, and on the way out of it, are the same branches of government that should always be subjected to the rule of law.

The financial crisis that started in 2008 led to a sharp reduction of credits globally, in its turn seriously reducing the availability of capital with ensuing dwindling growth, not least in the European Union. Governments and central banks acted in such a way that by 2011 a recovery was under way, although crisis management measures remained in place. Crisis loans administered by a troika consisting of the EU Commission, the International Monetary Fund (IMF) and the European Central Bank (ECB) were negotiated with Greece, Ireland, Portugal and Spain, countries that all had exceeded the ratio between public deficit and debt, and Gross Domestic Product, set out in Article 126 of the Treaty on the Function of the European Union (TFEU). As a consequence, the economic regulatory framework of the EU was strengthened along with institutional arrangements (including a European Banking Union, the European Stability Mechanism and other supervisory functions) that were swiftly established.

While the mechanisms that the EU has established for safeguarding the rule of law – notably Articles 2, 7 and 49 TEU – have remained unchanged and largely unused except in enlargement negotiations, the institutional and regulatory framework for financial stability has been both used and reinforced significantly under the pressure of expectations of the financial market and institutions. The Council of the EU, legally speaking one entity, behaves differently depending on whether it is dealing with a Member State violating Article 2 values, a Candidate Country seeking membership under Article 49, or a Member State disregarding its obligations to the Economic and Monetary Union. That the rule of law mechanisms have not been actively used is not due to lack of cases where they could have been applicable. Quite to the contrary, political developments in Europe over the past ten years demonstrate an increasing number and magnitude of challenges to rule of law compliance. It is rather the political will to use these mechanisms that has been largely absent.

For most actors unwillingly or unintentionally influencing the rule of law, the notion of an underlying or guiding concept of rule of law is probably not a

serious preoccupation. The unintentional or “accidental” promoters of the rule of law, i.e. actors who are in the “market” of rule of law for other reasons than promoting the rule of law, are normally exerting their influence for political or economic reasons. Although motivated by interests of financial stability, these actors will act in a normative way and regard certain developments as positive and others as negative for their market. The tools of coercion these actors employ are the investments or credits that will or will not be granted to a specific country, depending upon how the latter meets the expectations of the actors, and the inertia – in the form of levels of interest rates – this generates in the country’s relation with the international financial community.

The market actors’ main interests are the efficiency and the certainty in the legal and institutional system of a country. The legal systems likely to provide these features are those that are based on the principle of separation of powers, that have stable and clear legislation, and that have an administration and an independent judiciary that is not corrupt. The degree of discretion in public decision-making should also ideally be very limited. The elements of this rule of law conception do not differ radically from the EU conception (see fig. 7 below for the elements of the EU conception).<sup>2</sup>

This paper seeks to demonstrate the two different ways that the EU, on the one hand, and the market through reactions by credit rating agencies, on the other, both potentially reward and punish the same states for their progress and shortcomings with regard to rule of law compliance.

## **2 The Mechanisms for Promoting, Measuring and Reacting to Variations in Rule of Law Compliance**

### **2.1 *Actors Measuring the Rule of Law***

The concrete and empirically measurable strength of a rule of law concept could be seen as a combination of the complexity of the concept promoted as such and the strength and willingness of the polity projecting that concept; complex concepts could be suspected of requiring more strength and

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2 See *World Development Report 2005: A Better Investment Climate for Everyone*, New York: World Bank/OUP. See also Perry-Kessaris, A., *Enriching the World Bank’s Vision of National Legal Systems and Foreign Direct Investment*, in *Rule of Law Promotion: Global Perspectives, Local Applications*, eds. Bergling, P., Ederlöf, J., and Taylor, V., Uppsala 2009, p. 271 *et seq.* In his excellent work *On the Rule of Law*, Brian Tamanaha presents a table that captures most rule of law conceptions in an “organic system”. The different models - six generic types - are ranged from the thinner or most formal, to the broader or most substantive: (1) rule by law, (2) + formal legality, (3) + democracy and legitimacy, (4) + individual rights, (5) + the right to dignity and justice, (6) + social welfare rights. The divide between formal and substantive conceptions is drawn after conception 3. The elements of the different conceptions are presented, starting from the minimalist formal conceptions all the way to the most extensive and substantive conceptions. See Tamanaha, B., *On the Rule of Law; History, Politics, Theory*, Cambridge 2006, p. 91. See also Wennerström, E., *Measuring the Rule of Law*, in *Rule of Law Promotion: Global Perspectives, Local Applications*, eds. Bergling, P., Ederlöf, J., and Taylor, V., Uppsala 2009 (quoted as Wennerström 2009 below), p. 63 *et seq.*

determination of the projector. One way of projecting a concept is of course by using it to assess others, the result of the assessment being a positive or negative sanction in itself. Several tools and models have been developed for rule of law assessment, that normally cover the criminal justice system or those parts of the public administration that are directly associated with the criminal justice system. Among instruments of measurement developed by typical rule of law actors, we find *The Rule of Law Index*,<sup>3</sup> the *Judicial Reform Index (JRI)*<sup>4</sup>, the *Corruption Perception Index*,<sup>5</sup> and the Freedom House index *Freedom in the World (FIW)*.<sup>6</sup> Several other governance-related indexes and data-sources exist, specifically in relation with legal and judicial development that cover various aspects such as legislation, security and enforcement, access to justice and the status of the judiciary. The World Bank probably has the

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- 3 *The Rule of Law Index* was developed by the World Justice Project is the most recently launched comprehensive effort to measure qualitatively the extent to which countries around the world adhere to the rule of law, as defined by the project, providing detailed information on several different dimensions. The instrument will permit the identification of a country's strengths and weaknesses in comparison to similar countries, over time. See "[www.worldjusticeproject.org/rule-of-law-index/](http://www.worldjusticeproject.org/rule-of-law-index/)".
  - 4 The *Judicial Reform Index (JRI)* is a tool developed by the American Bar Association (ABA) Central European and Eurasian Law Initiative (CEELI), known today as the Europe and Eurasia Program, to assess the state of reform and the degree of independence in core justice sector institutions. Among the fundamental parameters active in the JRI are the standards established through the UN Basic Principles on the Independence of the Judiciary, the Council of Europe Recommendation on Independence of Judges, the European Charter on the Statute for Judges and the International Bar Association Minimum Standards for Judicial Independence. These international standards allow the JRI to be used in any regional context (it has been used in Africa, Asia, the Middle East, in addition to Europe and Eurasia since 2001). See "[www.abanet.org/rol/publications/judicial\\_reform\\_index.shtml](http://www.abanet.org/rol/publications/judicial_reform_index.shtml)". The results are standardized into a JRI country assessment report, where each factor is allocated a correlation value with a summary description, as well as a more detailed analysis of major shortcomings and trends in the specific system.
  - 5 The *Corruption Perception Index* developed by Transparency International measures the perception of corruption in individual countries. Like the World Bank indicators on governance, the Corruption Perception Index is a composite index based on surveys of business people and assessments by country specialists. Data from 14 separate sources at 12 different institutions on the frequency and size of bribes are used in calculating the Corruption Perception Index. See "[www.transparency.org/policy\\_research/surveys\\_indices/cpi/2009](http://www.transparency.org/policy_research/surveys_indices/cpi/2009)".
  - 6 *Freedom In the World (FIW)* is a well-known index in political science that assigns degrees of freedom to countries through numerical ratings of political rights and civil liberties. The average of the ratings determines whether a state is 'Free', 'Partially Free', or 'Not Free'. The sources include news reports, academic analyses, reports from non-governmental organizations, think tanks, individual professional contacts, and *in situ* observations. Part of the measuring process is based on a checklist consisting of 10 political rights questions and 15 civil liberties questions. See [www.freedomhouse.org/template.cfm?page=15](http://www.freedomhouse.org/template.cfm?page=15). See also Bergling, P., Bejstam, L., Ederlöv, J., Wennerström, E., and Zajac Sannerholm, R., *Rule of Law in Public Administration: Problems and Ways Ahead in Peace Building and Development*, Folke Bernadotte Academy, Stockholm 2008 (quoted as Bergling et al 2008 below), pp. 53–54.

most experience in assessing state performance.<sup>7</sup> The World Bank has developed several tools for measuring judicial capacity and rule of law propensity. The *Worldwide Governance Indicators* (WGI; also known as the *Governance Research Indicator Country Snapshot* (GRICS)) have been in use since 1996 and provides individual governance indicators for 212 countries and territories. The WGI consists of six indicators of governance performance: 1) voice and accountability, 2) political stability, 3) government effectiveness, 4) regulatory quality, 5) rule of law, and 6) corruption. However, the rule of law qualities that are measured are limited to contract enforcement, police performance, court performance, and the likelihood of crime and violence. The narrowness of this assessment may be a function of the subsuming of the rule of law under governance.<sup>8</sup> Taking the constitutional rule of law perspective or all six strata of Tamanaha's rule of law definitions, the WGI as a whole corresponds to indicators of constitutional rule of law compliance.<sup>9</sup>

The World Bank makes an important disclaimer on the first page of the WGI: this rating system will not be used for the allocation of resources. This is probably true in a strict sense, but the WGI project has hardly been financed and kept going over the years for the mere scientific thrill of aggregating numbers. The WGI and many other indices are being used, perhaps not directly for the shaping of decisions on funding, but indirectly, as supporting or refuting elements of other country-specific analyses made.<sup>10</sup>

The recent and still ongoing global financial challenges provide several examples of the necessity for certain actors to rapidly and frequently re-assess the reliability of companies and states that have issued instruments of debt on the financial market. It is a risk-assessment, and the price for borrowing money will follow that risk. As this relation is a well-known market function, it is possible to factor it into the behavior of companies and states. If a state or a company publicly declares that it believes its budget deficit is larger than its accounting shows, it will be hit by higher interest rates on its loans: it is risky. Different rule of law actors (or justice sector reform actors, good governance actors, etc.) have for decades been monitoring some of the same societal functions as the financial actors follow, albeit for other purposes, and in entirely different and more regular cycles. The assessments in the latter case do

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7 Unlike most other actors in the Justice and Public Administration Reform areas, the World Bank also has a generic definition of the rule of law, according to which the ambition is to supplant autocratic and state-centered systems with a rule of law system where the law: 1) operates in a way that is general and objective; 2) is administered based on knowledge of the law; 3) is accessible; 4) is reasonably efficient; 5) is transparent; 6) is predictable; 7) is enforceable; 8) protects private property rights; 9) protects individual and human rights; and 10) protects legitimate state interests. This operational definition contains elements that can be found in both formal and substantive rule of law definitions.

8 When governance as a whole is measured, the World Bank relies on the Aggregate Governance Indicators which comprise essentially identical indicators.

9 See note 2 above.

10 See Bergling et al 2008 p. 50 et seq., with references, Wennerström, E., *The Rule of Law and the European Union*, Uppsala 2007 (quoted below as Wennerström 2007), pp. 216-223, and "www.worldbank.org/wbi/governance/govdata/".

not lead to immediate penalties or rewards from the market, but they will in many cases be contributing to other assessments and evaluations that may influence what type of assistance the international community will be interested in providing to a particular country. And some of the assessments will find their way into the political assessments which entities such as the EU are regularly undertaking *vis-à-vis* their partners and sometimes into the assessments that market actors are making.

Although assessments and the very act of measuring may have a normative or coercive effect in itself, its impact on a country will depend on the projection power of the measuring entity. Iceland may serve as an example of this.

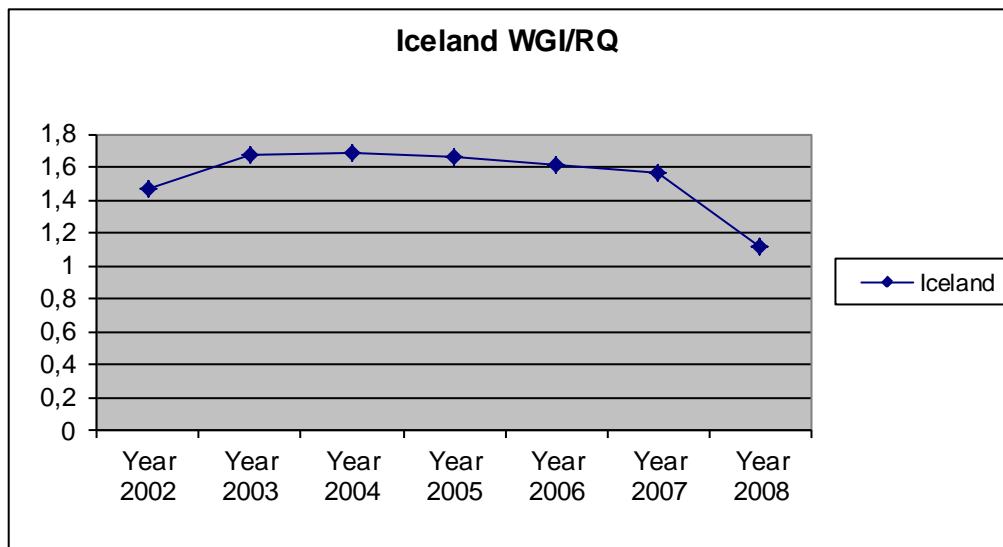


Figure 1: Regulatory quality of Iceland as measured by the World Bank WGI.

Something dramatic appears to have happened with the regulatory quality in Iceland, as perceived by the public and by experts, in the years immediately preceding the financial crisis in this country. The curve would enable us to trace the acts of commission or omission during the relevant period of time, which gradually eroded confidence in the regulatory mechanisms of the country. A performance index will seldom give us more precision than that, but with the assistance of the market-actors, we can pinpoint the crucial events more precisely: it was on the 30 September 2008 that Fitch Ratings altered its sovereign rating of Iceland as a state from A+ to A- with a negative warning. Just a week later, on 8 October, this rating was replaced by BBB-, shifting Iceland's financial quality from *Investment* closer to *Risk*. Neither Iceland nor any other actor reacted by introducing stricter compliance measures or by exerting any pressure as a result of the negative trend observed in the WGI. The shifted rating on 8 October 2008, however, led to an array of measures. The punishment by the market was the most dissuasive sanction Iceland

received for its regulatory failure; WGI assessment alone was not sufficient to trigger any change.

## 2.2 *Financial Market Actors Measuring the Rule of Law*

While the market forces that respond to a development – or the absence thereof – in a country are generally obscure or intentionally discreet and confidential,<sup>11</sup> there are some semi-official avenues for measuring these forces or rather: the likelihood of these forces acting in a certain direction. The level of foreign investment in a particular country is likely to reflect the profit opportunities and the legal as well as political security in that country, but this will tell us little about legal certainty in the criminal courts of that country. Investment-friendliness will depend on some important but yet limited aspects of the functioning of a country. A credit rating will capture more variables than just investment-friendliness, including more general levels of trust, stability and security for both domestic and foreign market actors dealing in and/or with the country.<sup>12</sup>

Reducing two very complex assessment branches in a simplistic way, one could say that *country risk* is a measure of the risk for investments and investment-related credits (export credits) concerning a country, the rating of which will determine the size of loss-insurance premiums, while *sovereign credit risk* is a measure of the risk for credits taken internationally being defaulted upon, the rating of which will determine the interest rates for such credits being negotiated internationally. This constitutes a significant leverage for change. As the transparency in the sovereign rating makes it possible to discern a set of coercion and incentives that is comparable over time to i.a. the EU's more incremental rule of law promotion, the former can be used to provide a comparative value for identical phenomena, in e.g. rule of law

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11 As in the case of the larger consulting firms making such assessments; KPMG, Deloitte, PwC, etc., all provide these services continuously. See e.g. “[www.kpmg.com/IN/en/WhatWeDo/Advisory/Risk-Compliance/GRCS/Pages/default.aspx](http://www.kpmg.com/IN/en/WhatWeDo/Advisory/Risk-Compliance/GRCS/Pages/default.aspx)”, “[www.deloitte.com/view/en\\_GX/global/services/enterprise-risk-services/index.htm](http://www.deloitte.com/view/en_GX/global/services/enterprise-risk-services/index.htm)”, or [www.pwc.com/gx/en/governance-risk-compliance-consulting-services/index.html](http://www.pwc.com/gx/en/governance-risk-compliance-consulting-services/index.html).

12 An adjacent measuring activity by the market for the market is country risk ratings, which should not be confused with sovereign credit rating, although both target countries as such. Country risk refers to risks related to investing in a country, dependent on changes in i.a. financial factors such as currency controls, devaluation or regulatory changes, or stability factors such as political unrest and other events that may contribute to risks. Under the aegis of the OECD, some country risk rating activities have been subjected to encouraged and assisted self-regulation, a process that has yet to take place with regard to sovereign credit rating. On the other hand, the transparency with regard to both methodology and results is significantly greater with regard to the leading sovereign rating agencies, than with the country risk agencies (apart from the OECD itself). The so called *Knaepen Package*, which came into effect in 1999, is a system for assessing country credit risk and classifying countries into eight country risk categories 0 - 7. See “[www.oecd.org/document/21/0,3343,en\\_2649\\_34171\\_1830178\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/21/0,3343,en_2649_34171_1830178_1_1_1_1,00.html)”.

assessments.<sup>13</sup> A sovereign rating compresses a large variety of information that needs to be known about the credit-worthiness of governments as issuers of bonds and other financial instruments. Ultimately, the risk that is being measured is the risk of the government defaulting on its financial obligations, or the probability of default.<sup>14</sup>

	21	20	19	18	17	16	15	14	13	12	11
<b>SP</b>	AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB-	BB+
<b>M</b>	Aaa	Aa1	Aa2	Aa3	A1	A2	A3	Baa1	Baa2	Baa3	Ba1
<b>F</b>	AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB-	BB+

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13 Some distinctions are necessary: CRAs may be recognized (recognized by supervisors in each country for regulatory purposes; in the United States, only five CRAs of which the best known are Moody's and Standard and Poor's (S&P) are recognized by the Security and Exchange Commission (SEC)) or non-recognized CRAs. The sovereign credit ratings of the recognized US agencies all indicate the capacity and willingness of governments to pay their commercial debts. See Bhatia, Ashok Vir, *Sovereign Credit Ratings Methodology: An Evaluation*, IMF Working Paper WP/02/170, 2002, p. 4. The majority of CRAs are "nonrecognized" (i.a. the Economist Intelligence Unit (EIU), Institutional Investor (II), and Euromoney). Following financial globalization, the importance of CRAs has increased, and accusations have been directed against them for overreacting - thereby aggravating financial crises - or for underestimating challenges, once a crisis is at hand. The high degree of concentration of the industry has also been criticized. The EU Council Conclusions of the Extraordinary meeting of ministers for economic and financial affairs (ECOFIN) on 9/10 May 2010, devoted to handling the peak of the Greek financial crisis, state that the ministers "underlined the need to make rapid progress on financial market regulation and supervision, in particular with regard to derivative markets and the role of rating agencies" [emphasis added], which is likely to maintain the issue on the political agenda. See Elkhoury, Marwan, *Credit Rating Agencies and their Potential Impact on Developing Countries*, UNCTAD Discussion Paper No. 186, 2008, p. 1, 10, 12 and 16.

14 The centrality of default risk should not convey the impression that this risk is considered to be overwhelming; after all, it is quite rare that countries default. The average investment grade risk was 0.88 % in 2002, while the average speculative grade risk ran at 19.48%. Nevertheless, there are always countries given the rating CCC, corresponding to a risk of close to 50% (or 46.87 % in 2002). Among noted sovereign defaults we find Pakistan 1998-1999, Russia 1998-2000, and Ecuador 1999-2000. Ratings of Moody's and Standard and Poor's are assigned by rating committees and not by individual analysts, as is the case with Fitch, and many non-recognized CRAs. See Bhatia, p. 11 and 29, and Elkhoury, pp. 2-4.



	10	9	8	7	6	5	4	3	2	1	0
SP	BB	BB-	B+	B	B-	CCC+	CCC	CCC-	CC	C+,C,C-	D
M	Ba2	Ba3	B1	B2	B3	Caa1	Caa2	Caa3	Ca	C	-
F	BB	BB-	B+	B	B-	CCC+	CCC	CCC-	CC	C+,C,C-	D

Figure 2: Equivalence between major rating schemes (SP = Standard and Poor's, M = Moody's, F = Fitch; the numerical equivalents 21 – 12 constitute investment grade ratings, whereas 11 – 1 fall in the category of speculative ratings).

Standard and Poor's sovereign ratings methodology focuses on nine broad parameters, out of which eight are more or less entirely economic and financial/fiscal.<sup>15</sup> The first parameter, however, coincides to a non-negligible degree with the political criteria for Candidate Countries to the EU and with i.a. the World Bank WGI as well as the Freedom in the World index and the Corruption Perception Index of Transparency International. This parameter is the political risk of the sovereign in question, and contains the following sub-parameters: a) stability and legitimacy of political institutions;<sup>16</sup> b) popular participation in political processes; c) orderliness of leadership successions; d) transparency in economic policy decisions and objectives; e) public security; and f) geopolitical risk. Regulatory strength and reliability will, however, also be a factor in some of the economic parameters. It should be stressed that non-economic factors have increased in importance in recent years when the rating agencies have developed their ratings-methodology.<sup>17</sup>

The coercive and behavior-directing element in the rating lies naturally in the fact that for a potentially borrowing sovereign country a rating downgrade has negative effects on its access to credit and the cost of its borrowing, i.e. as ratings go down, interest rates will go up. A behavior that this coercion will amplify is therefore downgrade-rating-avoidance, meaning that borrowing countries will adopt policies that address the short-term concerns of investors,

15 Income and economic structure; economic growth prospects; fiscal flexibility; general government burden; offshore and contingent liabilities, monetary flexibility; external liquidity, and external debt burden. Decisive variables tend to be GDP per capita, real GDP growth per capita, the Consumer Price Index (another "CPI", not to be confused with Transparency International's Corruption Perception Index, CPI), ratio of government fiscal balance to GDP, and government debt to GDP. *See* Elkhoury, p. 6.

16 Cf. the 1993 Copenhagen criteria for accession to the EU "Membership requires that candidate country has achieved stability of institutions guaranteeing democracy, the rule of law, human rights, respect for and protection of minorities..."[emphasis added].

17 *See* "www.standardandpoors.com/spf/ratings/How\_We\_Rate\_Sovereigns\_3\_13\_12.pdf", "www.fitchratings.com/creditdesk/reports/report\_frame.cfm?rpt\_id=685737", "www.moody.com/researchdocumentcontentpage.aspx?docid=PBC\_157547".

such as inflation fighting, even at the price of long-term development needs. Of the values set out in Article 2 TEU, respect for the rule of law is the closest counterpart to the factors that CRAs will consider, apart from purely economic and financial factors.<sup>18</sup>

It may be assumed that a country with a continuous political ambition to move upwards in any relevant rating system – not for rating reasons alone, but for the benefits that follow a higher or better rating – will be more susceptible to the normative messages of the rating community. Small movements in either direction within the speculative credit grade segment will matter less, than a move from speculative to investment grade ratings, and vice versa. This technique of measuring is in itself nevertheless both normative and coercive in its effects.<sup>19</sup>

### 2.3 *EU Mechanisms for Compliance*

It could certainly be argued that the supranational system of EU law being applied by the Member States under the supervision of the Court of Justice is the EU's greatest rule of law achievement. However, the judicial scrutiny will be restricted mainly to the areas of exclusive or shared competence, cf. Articles 3-4 TFEU, and will not touch the structure of a system of governance in the Member States per se and rarely their capacity for exercising power *vis-à-vis* their subjects. This limitation in policy areas – together with the refinement and

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18 See Elkhoury, pp. 4-5 and 11, and Standard and Poor's (October 2006). *Sovereign Credit Ratings: A Primer*.

19 The ratings committee of each credit rating agency (CRA) is the principal forum for all sovereign ratings. The basis for its deliberations is normally a ratings recommendation, supported by a draft report by the analyst with primary responsibility for the credit in question. A group of relevant analysts will constitute the committee, chaired by the most senior analyst present. In the deliberations, each parameter is debated and assigned a score by vote, as is ultimately the suggested rating, decisions that are binding. (There is even an appeals process, where sovereigns can ask committees to reconvene in order to consider new information.) After the committee's decision-making, the ratings report is amended accordingly and then published. Ratings committees are convened as and when necessary. During a normal and stable cycle, the ratings committee is convened after a country visit by the relevant analysts, with a visit frequency of between 6-24 months. The frequency depends on the volatility and prominence of the country. Ad hoc meetings can be convened, however, when rapid developments so demand. Political stability assessments are regularly made and aim to capture political event risk, together with assessments of "institutional depth, decision-making breadth, policy flexibility, global integration, geopolitical stability, and relations with official creditors." The political events that are risk-assessed include the likelihood of war, revolution, civil unrest, or extra-constitutional regime change. These events are seen as closely related to the risk of sovereign debt default. The factors that are considered in this political assessment include levels of democratization; concentration of decision-making; clarity of leadership-succession mechanisms; independence of the judiciary; freedom of the press. In addition to input from political observers, key data are derived from sources that include the Economist Intelligence Unit's *Country Reports* and *Country Profiles*, Transparency International's *Corruption Perceptions Index*, and Freedom House's list of "true" democracies. The cross-fertilization of indices, at least in one direction, is thereby institutionalized. See Bhatia, pp. 12-15.

intricacy of EU law, brings us far from even the relatively “thin” rule of law models that are part of the rule of law promotion efforts of the international community (the EU acting in other policy areas included) and is therefore left out of this analysis.<sup>20</sup> With regard to the options for coercive measures by the EU against one of its Member States outside the area of the *acquis communautaire*, apart from bridging arrangements such as the mechanisms included in the accession treaties of Bulgaria and Romania, the set of values applicable for all Member States is clearly set out in Article 2 TEU.<sup>21</sup> Article 7 TEU contains the sanctions that can be imposed for breach of the Union values, and demonstrates the full extent of the mechanisms through which the Union can ensure that the common values, including the rule of law, are respected by all Member States.<sup>22</sup>

The European Parliament constantly monitors the Member States, and reports annually on the situation in the EU and its Member States regarding fundamental rights and related areas, including the rule of law, but not in a very structured way. The role the Commission foresees for itself is that of the guardian of the treaties. On discovering a breach or a risk of breach of the Treaty values by a Member State, it would consider an Article 7 TEU proposal, contact the Member State in question and request its opinion on the situation. This would enable the Commission to present the facts it is considering and the Member State to comment on them, before any further action is taken. The Commission has so far not formally availed itself of this opportunity.<sup>23</sup>

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20 The monitoring by the Commission in the area of *acquis communautaire* is structured and detailed. See e.g. COM(2013) 726 final 30th Annual Report on Monitoring the Application of EU Law (2012).

21 Article 6 in Amsterdam and Nice versions.

22 Article 6 TEU makes the EU Charter of Fundamental Rights and Freedoms binding on EU institutions and Member States, when applying and implementing EU law. The sanctions relevant for breach of EU law and of the Charter in particular fall within the jurisdiction of the Court of Justice. This will no doubt have great implications for human rights, together with the future accession of the EU to the ECHR, but will not be dealt with here as the two procedures focus on rights violations, rather than system capacity and performance. Regarding the incremental and organic development of rule of law conceptions as a consequence of systems for monitoring individual rights violations, see Report on the rule of law - Adopted by the Venice Commission at its 86th plenary session (Venice, 25-26 March 2011), doc. CDL-AD(2011)003rev-e, with references. See also Wennerström, E., "EU Accession to the European Convention on Human Rights – the Creation of a European Legal Space for Human Rights or the Last Stand for the Normative Supremacy of the Strasbourg System?" in *Europarättslig Tidskrift*, Vol. 2/2013 pp. 375 – 386.

23 Such contacts would be of an informal nature, and would not prejudice the Commission's decision on submitting an Article 7 TEU proposal to the Council. See the series *Report on the fundamental rights situation in the European Union*, published annually starting 2002, by the EU Network of Independent Experts on Fundamental Rights. The reports are structured in accordance with the individual articles of the Charter, and could, given time, constitute a contribution to the *acquis* under the Charter. See COM (2003) 606 pp. 10–11. The role of the Fundamental Rights Agency (FRA) could in time to some extent fill the gap that appears to exist between developments in Member States and the Union's responsibility for safeguarding its values. FRA was inaugurated on 1 March 2007, with a mandate to collect analyze “data on fundamental rights with reference to, in principle, all rights listed in the Charter”, with a particular focus the application of EU law. There is

The possibility of sanctioning Member States that do not respect i.a. the rule of law was introduced with the Amsterdam Treaty, which came into force on 1 May 1999. Already before the end of that year the quality of the provisions in Articles 6 and 7 (now 2 and 7) TEU was put to the test. Following parliamentary elections in Austria, on October 3, 1999, the Conservatives (*Österreichische Volkspartei*, ÖVP) started government negotiations with a populist right-wing party (*Freiheitliche Partei Österreichs*, FPÖ). Following informal consultations the other 14 EU Member States agreed that they considered developments in Austria to pose a clear risk that an Austrian government, in which FPÖ had a role, would disregard the values enshrined in Article 6(1) of the Amsterdam Treaty. The coalition of 14 also agreed, however, that they could not take any action within the institutions of the EU, as Article 7 TEU did not authorize sanctions proceedings on the *anticipated* disregard for Article 6(1) TEU. The disregard had to be demonstrated by acts on the part of the “suspected” Member State before Article 7 TEU proceedings could be invoked.<sup>24</sup>

The fact that the coalition of 14 had been unable to use the only mechanism for defending the Union’s values to take pre-emptive or preventive action by imposing sanctions on a Member State, led to all Member States later accepting the amendments to Article 7 in the EU Treaty, which are now found in the Treaty of Lisbon. The Austrian and Italian cases of non-application of Article 7 TEU demonstrate the importance of having proper mechanisms in place to punish serious wrongdoings. The mere existence of the mechanism (certainly not just the value as such) acts as a deterrent, albeit apparently an insufficient one. The cases also show the importance of constant vigilance in monitoring the situation in the Member States as regards respect for democracy, fundamental rights and the rule of law. The task of monitoring the values and potential threats to them falls on the Member States and the Commission. The enlargement to 27 (and recently 28) Member States necessitated stronger monitoring, as the diversity between Member States was increased, and the continuing enlargement negotiations with other countries make monitoring even more important. Once the European Council (i.e. the Council “meeting in the composition of the Heads of State or Government”)

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room within that mandate to observe precisely such trends as are apparent from the WGI-data above. The legal basis for FRA is Council Regulation (EC) No 168/2007 of 15 February 2007. Its methods of operation are investigation, reports, provision of expert assistance to EU bodies, member states, and EU candidate countries and potential candidate countries, and the education of the public, concerning broad trends and horizontal issues.

24 The coalition, therefore, decided to act outside the EU institutions and apply a political suspension procedure, rather than a legal one, in an effort to dissuade ÖVP from governing together with FPÖ. The coalition was convinced (or at least had agreed) that the values in Article 6(1) TEU were threatened by the FPÖ, mainly because of the party’s expressed restrictive policies towards immigration. See Wennerström 2007 p. 141 with references. A similar situation did arise in 2001 to underline the need for amending the Treaty, as a coalition government was being formed in Italy led by Forza Italia, under Berlusconi, together with the controversial parties Alleanza Nazionale and Lega Nord. The Swedish President of the EU held consultations with the 14 other Member States where it was decided, in the absence of a “smoking gun”, to apply the provisions of Article 7 TEU strictly, i.e. a cautious wait-and-see-policy.

has determined that a breach exists according to Article 7(2) TEU, the Council (now the Council of Ministers) may decide by qualified majority to suspend the voting rights in the Council, and other rights, of the Member States in breach. The sanctioned Member State's obligations under the Treaty, notably to continue to pay its financial contributions, remain binding on the Member State, according to Article 7(3) TEU. The same qualified majority is required to lift the sanctions, see Article 7(4) TEU, and it is worth noting that when counting votes under the procedures of both Article 7(3) and 7(4), the votes of the Member States in question will be disregarded, cf. Article 7(5) TEU.

When the Nice Treaty came into force on 1 February 2003, the capacity of the Union to act against a Member State for lacking compliance in this specific regard was enhanced. The Amsterdam Treaty permitted remedial action only after a serious breach had occurred, whereas the Nice Treaty gave the Union a mandate to also act preventively, when a *clear threat of a breach* of the common values exists, albeit not as forcefully as when the breach is a fact.

What lies behind this reform is the realization that when a situation warranting censure arises, it will not be a clear-cut issue, as the Amsterdam text would suggest, i.e. "... the existence of a serious and persisting breach by a Member State of principles mentioned in Article 6 (1) ...". It is more likely to be a process taking place over time, requiring steps and thresholds. The underlying values in Article 6 TEU were not touched in Nice, nor was the distinction between Article 6(1) values – which could lead to censure – and Article 6(2) values – which could not. After Nice, the Treaty provides a *penalty mechanism* – evocable by recognition of the existence of a serious and persistent breach, Article 7(2) TEU – as well as a *preventive mechanism* – triggered by recognition of a threat of a serious breach, Article 7(1) TEU. The mechanisms remain unchanged in the Treaty of Lisbon and can be applied independently; they are not cumulative.<sup>25</sup>

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25 The breach or threat of a breach does not have to pertain to policy areas covered by the competence of the Union, i.e. it goes beyond the law of the Treaty, unlike for instance the application of the Charter on Fundamental Rights, cf. Article 6(1) TEU. This mirrors the fact that upon entering the Union, a Member State is scrutinized and monitored for more than simply the application of Treaty-related legal issues. That the mechanism in Article 7 is political is underlined by the discretion given to the Council once a proposal suggesting the existence of a threat or a breach is raised by the European Parliament, the Commission or one third of the Member States. The Council may decide to accept the proposal, but is not obliged to do so. Even if the Council does decide to accept such a proposal, Article 7(3) TEU does not oblige it to follow through and e.g. apply the penalties provided. The Council – in reality the Presidency – may decide to exhaust all the diplomatic channels in order to find a way out of a potentially disruptive situation, which the Court would never be able to do under similar circumstances, but then again the Council may have political points to gain by acting in strict accordance with the ultimate application of Article 7 TEU. This was surely the case in the Austrian situation, where the leading voices of the coalition of 14 acted just as much for the benefit of their own constituencies back home, as for the safeguarding of the Union's values. When the Italian situation occurred later, the Member States could have done the same thing but chose not to, probably less inclined by the newly adopted amended text of the Treaty, than by the fact that no political points were to be gained so shortly after the first demonstration. See COM (2003) 606 p. 3 *et seq.*

On 11 March 2014 the EU Commission issued a Communication on "A new EU Framework to strengthen the Rule of Law"<sup>26</sup> in which it outlines a "framework" or structure for how it intends to use its powers with regard to systemic threats to the rule of law in any of the EU's Member States. This framework is complementary to traditional infringement procedures, which can only be used when EU law has been breached, and to the Article 7-procedure of TEU which ultimately allows for the suspension of voting rights in case of a "serious and persistent breach" of EU values by a Member State. The EU framework establishes an early warning tool to deal with threats to the rule of law, allowing the Commission to enter into a dialogue with the concerned Member State in order to find solutions before the existing legal mechanisms set out in Article 7 of the Treaty are to be used. Should no solution be found, Article 7 still remains the last resort to resolve a crisis and ensure compliance with European Union values. The new framework does not constitute or claim new competencies for the Commission but makes transparent how the Commission exercises its role under the Treaties.

The framework is naturally based on the EU Treaties and complements existing instruments, notably the Article 7 procedure and the Commission's infringement proceedings. It is focused on the rule of law, which for the first time is positively defined by the Commission, drawing on principles set out in the case law of the European Court of Justice and the European Court of Human Rights, amounting to a definition that is closely aligned to the definition presented by the Venice Commission in 2011 partially on the basis of the same case law.<sup>27</sup>

The stated intention of the Commission is to activate the framework in situations where there is a systemic breakdown which adversely affects the integrity, stability and proper functioning of the institutions and mechanisms established at national level to secure the rule of law in a Member State, but not in individual situations or isolated cases of breaches of fundamental rights or miscarriages of justice.

The equality of all Member States, large and small, is underlined by the Commission, that also stresses that the same benchmarks as to what is considered a systemic threat to the rule of law will be used for all.

While the European Commission plays a central role in this new rule of law framework as the independent Guardian of the Union's values and treaties, the Communication also recognizes the need to be able to draw on the expertise of other EU institutions and international organizations (notably the European Parliament, the Council, the Fundamental Rights Agency, the Council of Europe, and the OSCE.).

The three-stage process the Commission foresees, in order to prevent the emerging of a systemic threat to the rule of law that could develop into a "clear risk of a serious breach", triggering the use of Article 7 TEU, is a "pre-Article 7 procedure". The first stage consists of the Commission assessment as to whether there are clear indications of a systemic threat to the rule of law. If, as

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26 COM(2014) 158 final.

27 CDL-AD(2011)003rev.

a result, the Commission is of the opinion that there is indeed a situation of systemic threat to the rule of law, it will initiate a dialogue with the Member State concerned, by sending its "rule of law opinion", which will be a warning to the Member State – and substantiating its concerns. It will give the Member State concerned the possibility to respond.

If the first stage does not lead to a satisfactory resolution of the problem, the second stage is a formal Commission Recommendation, a "rule of law recommendation" addressed to the Member State similar to the reasoned opinions the Commission uses as a pre-process-instrument in infringement proceedings. This instrument will recommend the Member State to solve its identified problems within a fixed time limit and inform the Commission of the steps taken to that effect. The Commission will make its recommendation public. The third stage is the Commission monitoring the follow-up to its Recommendation. Failing satisfactory follow-up within the time limit set, the Commission can resort to one of the mechanisms set out in Article 7 TEU.

The entire process is based on a continuous dialogue between the Commission and the Member State concerned, and the Commission will keep the European Parliament and Council regularly and closely informed.

The role of the rule of law criterion of the EU during the big enlargement 1997-2004 is the leading EU example of a rule of law concept in action. The Commission Opinions of 1997 on the state of preparedness of the Candidate Countries for EU accession set the tone for the subsequent screening process. Although some fine-tuning took place with every subsequent year, the parameters that were considered important for the fulfillment of the rule of law remained relatively constant. Certainly no declaration was made as to what vision of the rule of law the Candidate States were to achieve in order to satisfy the Commission and the EU's requirements. The definition by EU enlargement action following the 1997 Opinions is a rough estimate as regards the quality of the different sub-components of an EU rule of law enlargement concept, but nevertheless the clearest estimate available.<sup>28</sup>

For the EU, the rule of law is a prerequisite for membership of the EU (Article 49 TEU) and a founding principle for the Union itself (Article 2 TEU). The empirical data derived from the Commission's documentation of its assessments, and the Council's decisions based on it, provide an outline of four main, broad areas of assessment as regards the rule of law: supremacy of law, separation of powers, judicial independence, and certain (procedural) fundamental rights,<sup>29</sup> as well as a fifth value (or rather: activity) that is unique in this context: corruption.<sup>30</sup> Once the process was under way, the efficiency of

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28 See Commission Communication COM (97) 2000, in EU-Bulletin Supplement 5/97. See also Wennerström (2007), pp. 188 and 212-223.

29 Notably *audiatur et altera pars*, *non bis in idem*, and *nulla poena sine lege*.

30 These values, apart from corruption, correspond to the concept used by the Court of Justice for internal EC purposes. In order for a Candidate State to assure the Commission that the rule of law criterion was met, the most important factor appears to be a demonstrated willingness to move in the right direction, not necessarily to meet a specific target; the Commission knew that the ideal system does not exist. See Wennerström (2009), p. 68 *et seq.*

the different parts of the system necessary for upholding the rule of law became the main focus of attention.

The political overtones in the enlargement process do, however, inject obscurity and doubt as regards the willingness of the EU (and its Member States) to wholeheartedly use the mechanism it has established for projecting the values of the Treaty. The strength of the sanctioning mechanism – non-accession or delayed accession – in Article 49 and Article 2 TEU is considerable and has a persuasive effect that is also considerable. Time appears to be the third factor that comes into play here: the projection of values is permitted to take time, but if it takes too much time, the threshold is in some cases lowered (most Candidate States that acceded in 2004 did not meet all conditions), and in other cases the time is extended (as with Bulgaria and Romania).<sup>31</sup>

Incentives could play an important role in normative coherence, but without normative clarity it is even under the best of circumstances unclear whether the types of incentives that EU presents (progress in enlargement negotiations, funds for restructuring and reinforcing relevant parts of national administration, and ultimately: membership and the political and economic benefit this means) actually promote singular values or goals in a discernable way. The first and foremost EU incentive is the attraction of EU membership – this is widely regarded as the strongest incentive, and it is this incentive that makes enlargement conditionality possible. The enlargement conditionality is in its turn combined with the availability of financing instruments, with considerable resources made available for strengthening public administration and Member State institutions to function effectively inside the EU, for promoting

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31 *See* Commission Communication COM (2006) 549. Three different safeguard clauses have later been added: a general economic safeguard clause, a specific internal market safeguard clause, and a specific justice and home affairs safeguard clause. In addition to the safeguard clauses, the Acts of Accession for Bulgaria and Romania contain a postponement clause, Article 39. The postponement clause could have been applied if the Commission had found that the acceding state is manifestly unprepared to meet the requirements of membership in a number of policy areas. As the monitoring reports of the Commission concerning Bulgaria and Romania did not recommend postponement, the two countries joined the Union as planned on 1 January 2007. The clauses can be used for three years following accession. *See* e.g. Treaty of Accession of the Republic of Bulgaria and Romania, signed in Luxembourg on 25 April 2005, Commission doc. MEMO/05/396, of 25 October 2005, COM (2006) 549, OJ L 236, of 03.04.2003. The aspect of the rule of law criteria that is most surprising in the evaluation process is the presence of active measures to counteract corruption. “Surprising” not with regard to the situation in the countries in question – corruption was and is still a serious problem there – but surprising in how it was elevated to the status of a sub-criterion of its own, rather than part of e.g. the analysis of the independence of the judiciary. In none of the classical models of the rule of law does corruption take center stage in the same way as it did during the 5th enlargement. Here, very few Candidate States made the grade. An overwhelming majority were severely criticized from the outset, up to the moment that they, or most of them, were considered generally ready for accession. This can only mean that active measures to counter corruption are entirely relative – there is no lower threshold to cross, only possibly a necessity to be seen to be doing something in this field, some tangible act or manifest intention.



convergence with the *acquis communautaire*, and to promote economic and social cohesion.<sup>32</sup>

While several individual projects financed under these instruments have been very successful, in the sense that the goals set for each project have been met,<sup>33</sup> and no doubt the main objectives of the financing instruments have been met in all instances, it is difficult – despite serious attempt known to the authors – to establish that the financing instruments have provided incentives for normative compliance in the specific area of rule of law, although they may certainly have supported such general ambitions with the governments in question. Projects are often described at a nuts-and-bolts-level that makes it hard to trace the effects of successful implementation to specific overriding values, other than with sweeping statements.

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32 For the 2004/2007 enlargement, the main instrument was PHARE, for the countries of the Western Balkans the instrument has been CARDS, since 2007 replaced by the Instrument for Pre-Accession Assistance, IPA. Unlike its predecessors, IPA offers funds to both EU candidate countries and potential candidate countries. The working methods developed under PHARE, more or less still apply in later financing programs, at least as regards the general methodology. See “[ec.europa.eu/enlargement/how-does-it-work/financial-assistance/phare/programmes\\_types\\_en.htm](http://ec.europa.eu/enlargement/how-does-it-work/financial-assistance/phare/programmes_types_en.htm)” National programs or envelopes would be negotiated bilaterally between the EU and each partner country. Annual progress reports would allow the EU to identify weaknesses in the candidate countries’ ability to adopt the *acquis* or fulfill other accession criteria, and suggest types of actions that need to be undertaken. It is then for each candidate country to draw up its National Programme for the Adoption of the Acquis (NPAA), with a timetable for its planned measures to rectify identified problems and the resources needed for this purpose.

33 See the European Commission’s own selection of projects that have been successfully carried out at “[ec.europa.eu/enlargement/projects-in-focus/selected-projects/index\\_en.htm](http://ec.europa.eu/enlargement/projects-in-focus/selected-projects/index_en.htm)”.

EU-definition (until 2014)	World Bank WGI definition	CRA-definition
<p>EU Enlargement Rule of Law criteria</p> <ul style="list-style-type: none"> <li>-) supremacy of law,</li> <li>-) separation of powers,</li> <li>-) judicial independence,</li> <li>-) respect for procedural fundamental rights, and</li> <li>-) active measures to counter corruption</li> </ul> <p>The 1993 Copenhagen criteria for accession to the EU " Membership requires that candidate country has achieved <i>stability of institutions</i> guaranteeing democracy, the rule of law, human rights, respect for and protection of minorities..."</p>	<p>World Bank WGI</p> <ol style="list-style-type: none"> <li>1) voice and accountability,</li> <li>2) political stability,</li> <li>3) government effectiveness,</li> <li>4) regulatory quality,</li> <li>5) rule of law, and</li> <li>6) corruption</li> </ol>	<p>CRA sovereign political risk</p> <ol style="list-style-type: none"> <li>a) stability and legitimacy of political institutions;</li> <li>b) popular participation in political processes;</li> <li>c) orderliness of leadership successions;</li> <li>d) transparency in economic policy decisions and objectives;</li> <li>e) public security; and</li> <li>f) geopolitical risk</li> </ol>

Figure 3: Comparison between the three different types of rule of law-conceptions being used in assessments.

Until recently – i.e. until 11 March 2014 and the publication of Communication 158 – the only idea of what the EU saw as a rule of law definition was found in its practice during enlargement, the most consistent application of a rule of law condition over time. This coincides to a considerable degree with the parameters measured by the World Bank Institute in the WGI, if we replace rule of law with governance (for the World Bank Institute, the rule of law is something narrower than what the EU would infer by the term). This in turn comes fairly close to some of the parameters the big 3 CRAs have declared to be vital for their measuring of political risk. The effects of the three sets of measurement are significantly different. The first may stand in the way of a country's membership of the EU, the second does not have any particular primary power attached to it, while the third has the power to affect a country's standing on the international financial market.

### 3 EU Compliance as Measured, Rewarded and Sanctioned

The financial crisis was not surprisingly the single largest factor affecting the credit ratings of the EU Member States in recent years, as especially demonstrated by the case of Greece. The crisis in Eurozone cooperation also had major impact on credit ratings for the participating countries after the EU Summit in December 2011. The internal EU compliance mechanisms appear to be rather insensitive to variations in rule of law compliance between Member States, if this compliance is judged by other mechanisms, e.g. the World Bank's indicators.

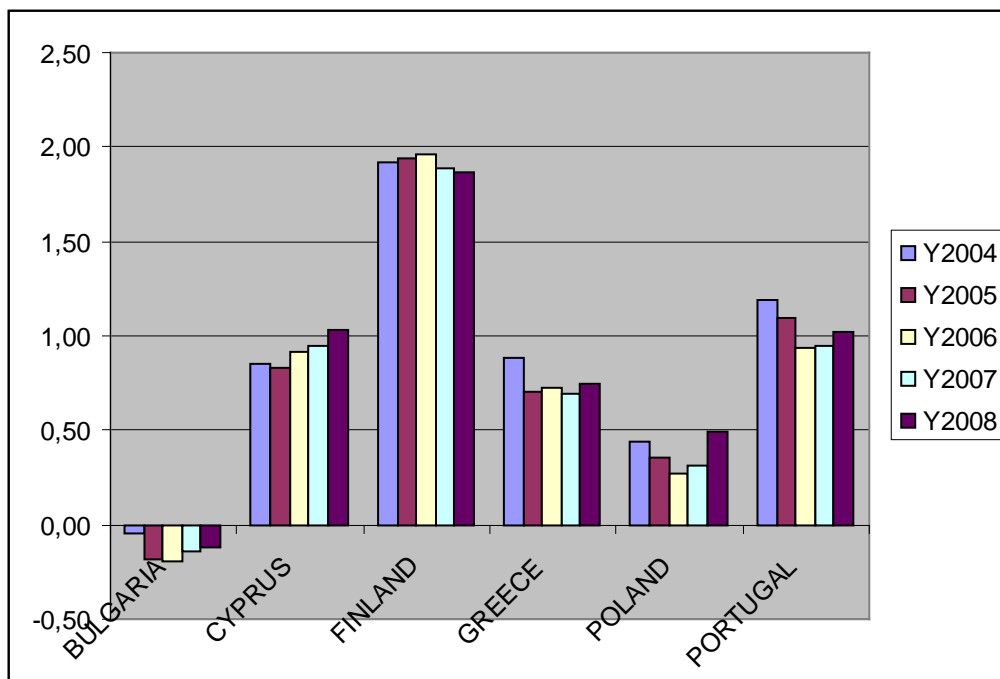


Figure 4: WGI/Rule of Law assessment 2004 – 2008 of six EU Member States (scale ranges from -2,5 to +2,5).

The figure above describes a quite radical differentiation in rule of law compliance during a period of only the five years leading up to the financial crisis, where the difference between the “old” Member States Finland and Greece is as big as it is between Portugal and one of the Candidate Countries that were put on hold for negative rule of law-reasons: Bulgaria. In comparison with other types of assessments, the disparity in rule of law quality outside the area of *acquis communautaire* may be quite significant – and even demonstrate substantial fluctuations – without the EU-mechanisms reacting.

With the introduction of the preventive mechanism in Article 7 TEU, the mandate for vigilance of the Union bodies was increased. The risk in the Austrian case could be described as based upon proclamations made by the FPÖ leadership. There appeared to be a clear risk that a government influenced by that party would become xenophobic, thus possibly violating elements of

international law, elements that are part of the common values of the Union. If that government would have acted in that way, the situation would no longer constitute a risk but would qualify as an outright breach that would possibly be judged as serious and persistent.<sup>34</sup>

The application of the Article 7-procedures is, however, entirely political. Article 269 TFEU gives the ECJ jurisdiction only over the legality of Article 7 TEU decisions taken by the Council. And it is noteworthy that following the expansion of its potential field of application, this article has not been invoked even once since it was amended at Nice 2000.<sup>35</sup> The constitutional modifications carried out in Hungary following the parliamentary election in 2010 of the alliance of *Fidesz-KDN*, have led to serious international criticism and the adoption of soft law-measures by the European Parliament, but no activation of the Article 7 TEU-procedures.<sup>36</sup> Following the 2010 general

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34 Whether or not a risk or a breach is serious will be determined on the basis of the purpose and the result of the breach. If the purpose and result are consistent with the breach, it is easier to determine the seriousness of the breach. If it for instance is a government's aim to discourage asylum-seekers from entering the country, by abolishing all recourse to appeal in its procedures thus abolishing asylum-seeking itself, there is full consistency between purpose and result, and we would have a clear breach. If, on the other hand, a government aims to reduce backlogs in all administrative procedures and therefore reduces the possibilities for appeal, the case is less clear. An indicator of the seriousness of a breach could be the simultaneous breach of more than one of the Article 2 TEU values. For a breach to be persistent, which is only relevant for the penalty mechanism in Article 7(2), there must be a measurable duration of the breach. The introduction of legislation is in itself a durable act that would qualify more or less immediately, as soon as no additional measures of implementation are needed. Repeated instances of individual breaches may also be an indicator of a persistent breach under Article 7 TEU. If, in addition, a Member State's acts have been criticized by other normative bodies, such as the European Court for Human Rights, and the Member State persists in its actions, that is certainly another factor that has to be taken into account. With future EU accession to the ECHR, cf. Article 6(2) TEU, this aspect may take on a more institutionalized relevance. *See* COM (2003) 606 pp. 7-8.

35 It could be argued, that for instance the coalition brought into power in Denmark following general elections in 2001, would at least have raised the issue of whether or not EU values would in any way be jeopardized. The coalition contained one party – Dansk Folkeparti – with a program that resembled that of the FPÖ. The party later entered new coalition governments following elections in 2005 and 2009, without triggering such considerations.

36 *See* European Parliament resolution of 3 July 2013 on the situation of fundamental rights: standards and practices in Hungary (pursuant to the European Parliament resolution of 16 February 2012), doc. A7-0229/2013, and the following opinions adopted and published by the Venice Commission: Comments of the Government of Hungary on the Draft Opinion on the Fourth Amendment to the Fundamental Law of Hungary (CDL-REF(2013)034), Draft Opinion on Act CXII of 2011 on informational self-determination and freedom of information (CDL(2012)065), Draft Opinion on the Cardinal Acts on the Judiciary that were amended following the Adoption of Opinion CLD-AD(2012)001 on Hungary (CDL(2012)054), Draft opinion on the Act on the rights of nationalities of Hungary CDL(2012)040, Draft opinion on act CLI of 2011 on the Constitutional Court of Hungary (CDL(2012)037), Draft opinion on Act CLXIII of 2011 on the prosecution service and Act CLXIV of 2011 on the status of the prosecutor general, prosecutors and other prosecution employees and the prosecution career of Hungary (CDL(2012)036), Draft joint opinion on the Act on the elections of Members of Parliament of Hungary (CDL(2012)033), Draft opinion on act CCVI of 2011 on the right to freedom of conscience and religion and the

election in the Netherlands and until the elections in 2012, the PVV (*Partij voor Vrijheid en Vooruitgang*) entered a supportive alliance with the conservative minority government. The PVV's political program revolves around xenophobia and criticism of Islam. The coalition did not trigger discussions on the possibility of Article 7 TEU-procedures.

The EU enlargement Article 49 TEU-compliance mechanisms present a more detailed and refined system for monitoring than the Article 7-system, as can be seen from figure 5 below.<sup>37</sup> The structured observations that are repeated annually depict progress, or the absence thereof, to be monitored over time, and to be compared with other states that are or have been monitored by the same mechanism.

	1997	1998	1999	2000	2001	2002
<b>BG</b>	SL: substd SP: OK JI: substd FR: substd AC: substd	SL: substd SP: OK JI: substd FR: substd AC: substd	SL: substd SP: OK JI: substd FR: substd AC: substd	SL: OK SP: OK JI: substd FR: OK AC: substd	SL: OK SP: OK JI: substd FR: OK AC: substd	SL: OK SP: OK JI: substd FR: OK AC: substd
<b>CZ</b>	SL: OK SP: OK JI: substd FR: substd AC: substd	SL: OK SP: OK JI: substd FR: OK AC: substd	SL: OK SP: OK JI: substd FR: OK AC: substd	SL: OK SP: OK JI: substd FR: OK AC: substd	SL: OK SP: OK JI: ? FR: OK AC: substd	SL: OK SP: OK JI: substd FR: OK AC: substd
<b>EE</b>	SL: OK SP: OK JI: substd FR: OK AC: substd	SL: OK SP: OK JI: substd FR: OK AC: ?	SL: OK SP: OK JI: ? FR: OK AC: substd	SL: OK SP: OK JI: substd FR: OK AC: OK	SL: OK SP: OK JI: substd FR: OK AC: OK	SL: OK SP: OK JI: substd FR: OK AC: OK
<b>HU</b>	SL: OK SP: OK JI: ? FR: OK AC: substd	SL: OK SP: OK JI: ? FR: OK AC: substd	SL: OK SP: OK JI: ? FR: substd AC: substd	SL: OK SP: OK JI: substd FR: OK AC: substd	SL: OK SP: OK JI: substd FR: OK AC: substd	SL: OK SP: OK JI: OK FR: OK AC: substd
<b>LV</b>	SL: OK SP: OK JI: substd FR: substd AC: substd	SL: OK SP: OK JI: substd FR: OK AC: substd	SL: OK SP: OK JI: substd FR: OK AC: substd	SL: OK SP: OK JI: substd FR: OK AC: substd	SL: OK SP: OK JI: substd FR: OK AC: substd	SL: OK SP: OK JI: substd FR: OK AC: substd
<b>LT</b>	SL: OK SP: OK JI: substd FR: OK	SL: OK SP: OK JI: substd FR: OK	SL: OK SP: OK JI: substd FR: OK	SL: OK SP: OK JI: substd FR: OK	SL: OK SP: OK JI: substd FR: OK	SL: OK SP: OK JI: substd FR: OK

legal status of churches, denominations and religious communities of Hungary (CDL(2012)010), Draft opinion on act CLXII of 2011 on the legal status and remuneration of judges and act CLXI of 2011 on the organisation and administration of courts of Hungary (CDL(2012)005), Draft opinion on the new constitution of Hungary (CDL(2011)032), and Draft Opinion on three legal questions arising in the process of drafting the new constitution of Hungary (CDL(2011)016).

37 The whole sequence of EU scrutiny is available in the individual country reports issued between 1997 and 2004. For references, see Wennerström 2007 pp. 309 *et seq.*

	AC: substd	AC: substd	AC: substd	AC: substd	AC: substd	AC: substd
<b>PL</b>	SL: OK SP: OK JI: ? FR: OK AC: substd	SL: OK SP: OK JI: ? FR: OK AC: ?	SL: OK SP: OK JI: substd FR: OK AC: substd	SL: OK SP: OK JI: ? FR: OK AC: substd	SL: OK SP: OK JI: substd FR: OK AC: substd	SL: OK SP: OK JI: substd FR: OK AC: substd
<b>RO</b>	SL: ? SP: ? JI: substd FR: ? AC: substd	SL: ? SP: ? JI: substd FR: ? AC: substd	SL: substd SP: substd JI: substd FR: substd AC: substd	SL: substd SP: substd JI: substd FR: OK AC: substd	SL: ? SP: ? JI: substd FR: OK AC: substd	SL: substd SP: substd JI: substd FR: OK AC: substd
<b>SK</b>	SL: substd SP: substd JI: substd FR: ? AC: substd	SL: substd SP: substd JI: substd FR: ? AC: substd	SL: substd SP: substd JI: substd FR: substd AC: substd	SL: OK SP: OK JI: substd FR: OK AC: substd	SL: OK SP: OK JI: OK FR: OK AC: substd	SL: OK SP: OK JI: OK FR: OK AC: substd
<b>SL</b>	SL: OK SP: OK JI: ? FR: ? AC: substd	SL: OK SP: OK JI: ? FR: ? AC: OK	SL: OK SP: OK JI: substd FR: ? AC: OK	SL: OK SP: OK JI: OK FR: OK AC: OK	SL: OK SP: OK JI: OK FR: OK AC: OK	SL: OK SP: OK JI: OK FR: OK AC: OK

Figure 5: The Commission's assessment in annual reports throughout the accession process on the five rule of law elements (SL = supremacy of law, SP = separation of powers, JI = judicial independence, FR = respect for procedural fundamental rights, and AC = active measures to counter corruption; "OK" = no criticism, "subst" = sub-standard, according to assessment, and "?" = clear position cannot be deduced from report).

The shortcomings of this form of assessment are primarily two. First of all, there are no degrees in compliance measured. Secondly, the fact that the sanction/reward function of the mechanism is entirely political does to some extent deprive it of its teeth, as agreement on membership can and often will be reached without full compliance having been observed. Thus, only Slovenia was in full compliance when the political reward of membership was given to *all* negotiating states, apart from Bulgaria and Romania that were truly sanctioned for non-compliance.

The market, however, makes no such provisions for political necessities and the enlargement process offers several examples of the effects of the combination of EU- and market influence in the direction of rule of law compliance. If we observe the strength of the various components that made up the EU rule of law conception as applied, it is clear that certain benchmarks were considered more important than others, and that certain components were measured in a binary, on/off way, whereas other components were seen from a more dynamic more progress/less-progress perspective. While this encapsulates the behavior of the Commission, it also depicts the second dimension of the emerging concept, i.e. with what strength can and will the EU apply this conception to situations that fall within its jurisdiction or remit. The examples are few, but telling. Slovakia was excluded from the process for failing to meet the separation of powers criterion and, thereby, also the

supremacy of law, as the separation of powers was a requirement under Slovakia's own constitution. Bulgaria was not excluded from the process – its failure supposedly being less grave than Slovakia's – but had, together with Romania, its entry date postponed for not having met the corruption standard required; consequences were activated as a result of non-compliance. The last monitoring reports on Bulgaria and Romania of 16 May 2006 confirmed the ongoing progress towards fulfilling the rule of law criteria.

The CRAs monitor political stability, transparency, predictability, flexibility and government ability to make decisions in their assessments of countries. Political risks and volatility can generally be seen to contribute to downgrades in credit ratings, as can upcoming elections with uncertain outcomes that contribute to uncertainty about a future government's ability to act. The stability and effectiveness of a government is a key factor in sovereign credit rating.

The ratings of Germany, Luxembourg and the Netherlands have remained unchanged over the last 10 years, as only their outlook has changed for the negative, as a result of economic trends. Denmark, Finland and Sweden (all of which were upgraded for financial reasons, meeting the requirements for the AAA-rating) received the highest rating-level in the early 2000s and have since remained at the same level. Common to these countries is that they have received the highest credit rating by all rating institutions and it would require a serious turn for the worse for a downgrade to take place in such a case. It did, however, happen in the case of France, which was downgraded because of the crisis in the Eurozone in December 2011, which affected France negatively. The government was not perceived to address the crisis efficiently, neither through reforms nor through structural changes. To a large extent the downgrades of Ireland's rating since 2009 was also due to the financial crisis, but the government's strong commitment to fiscal consolidation and structural reforms, as well as its commitment in response to the financial crisis offset the rating from being downgraded further. Belgium's credit rating was lowered to a certain degree due to the financial crisis facing the European countries from 2008, but just as much as a consequence of the political uncertainty in the country. Both Standard and Poor and Moody explicitly quoted Belgium's political uncertainty and its lack of a federal government due to failed coalition negotiations as basis for the negative assessment.<sup>38</sup>

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38 See e.g. "www.moody's.com/research/Moodys-downgrades-Belgiums-credit-ratings-to-Aa3-negative-outlook--PR\_233667". "Belgium's recent experience of political bargaining indicates that consensus on additional measures can be difficult to achieve."

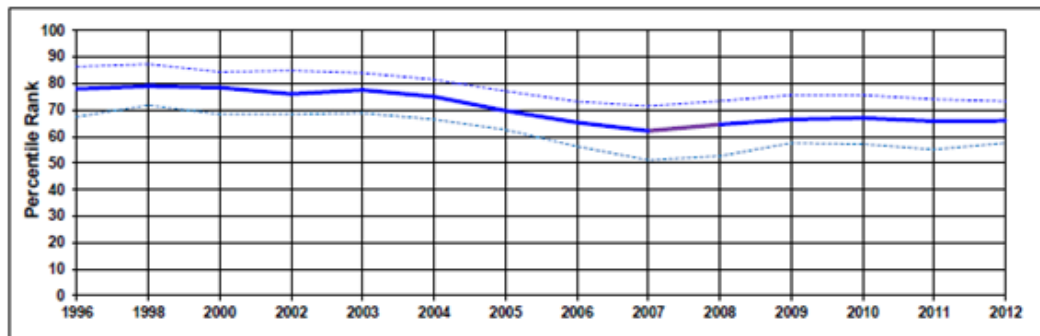
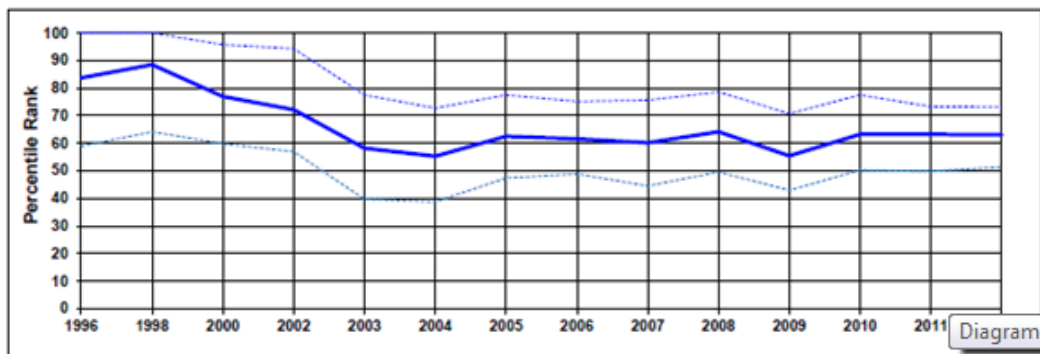
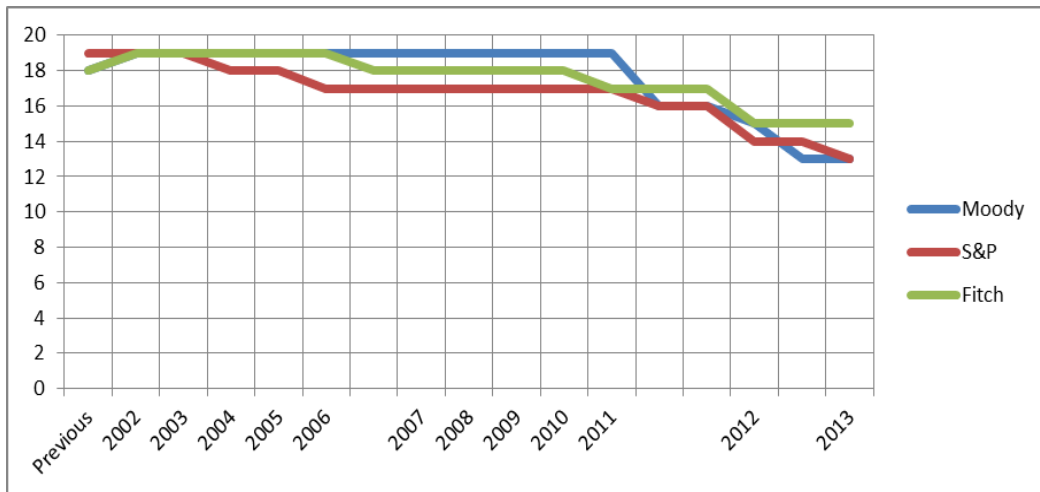


Figure 6: Italy sovereign credit ratings and World Bank WGI indicators (political stability and absence of violence, and government effectiveness) 1996 – 2012.

The financial crisis did not hit Italy as hard as was first expected, simply because its credits were mainly domestic. But its share of the crisis was aggravated by Italy's weak structural institutions and inability to implement reforms. This happened in a downward trend, according to WGI, that started long before the financial crisis, actually during Berlusconi's second term. The EU mainly reacted to the challenges to the common currency.



Political issues in Italy during the last years, including the so called Berlusconi affair, corruption charges etc. did not affect the ratings until 2011. The “technocratic” government, formed in November 2011 after Prime Minister Berlusconi resigned, did have a positive effect on the ratings, as it implemented substantial reforms and created a better policy environment. But the CRAs doubted if a subsequent politically elected government could reinstate the public’s and the investors’ trust, which effected the rating negatively, as a weak coalition government contributed to Italy not being able to meet challenges decisively.<sup>39</sup>

Weak coalitions can generally be seen to affect the rating negatively. Minority governments may not *per se* have a negative ratings effect; see e.g. Portugal where a minority government had a strong mandate across party lines with strong commitment to reform, leading to improved ratings, as it was considered to reduce uncertainty. The violent reactions in Greece to the introduction of reforms and austerity measures affected its ratings negatively, while the broad consensus in both Portugal and Ireland on the necessity of reform affected the ratings positively. The unrest in Latvia, resulting in the resignation of the government in 2009, created political uncertainty and affected the rating negatively.<sup>40</sup>

The level of corruption in a state has importance for the rating, especially when it appears to affect the country’s ability to carry out reforms. However, in the case of Italy, the corruption allegations related to Prime Minister Berlusconi did not at first have a major impact on the rating as Italy was considered to have a functioning economy and political stability until 2011.

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39 See notably “[www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC\\_143879](http://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_143879)”. “The political climate, particularly as the Spring 2013 elections draw near, is also a source of implementation risk. The current government, which is expected to remain in power until April 2013, is currently being tested on its capacity to transform the country in key fiscal and economic areas. It is unclear at this stage to what extent political parties in Italy will be able in coming months to restore voter and investor confidence in the political landscape and whether we can expect a smooth handover from a technocratic government to a newly elected political government that is able to continue with the reforms that have been set in motion. Italy’s government debt rating could be downgraded further in the event that these political risks crystallize and there are difficulties in implementing reform.”

40 See “[www.fitchratings.com/creditedesk/press\\_releases/detail.cfm?pr\\_id=467419](http://www.fitchratings.com/creditedesk/press_releases/detail.cfm?pr_id=467419)”. “The downgrade of Latvia’s ratings reflects the deterioration in the prospects for the Latvian economy and elevated risk of policy slippage since the agreement of the EUR7.5bn loan package with the IMF, EU and other international lenders in December 2008.” “Austerity measures implemented following the agreement with the IMF, EU and other international lenders in December 2008 contributed to a public backlash culminating in demonstrations in Riga in mid-January 2009 which led to the collapse of the four-party coalition government led by Prime Minister Ivars Godmanis in February.”

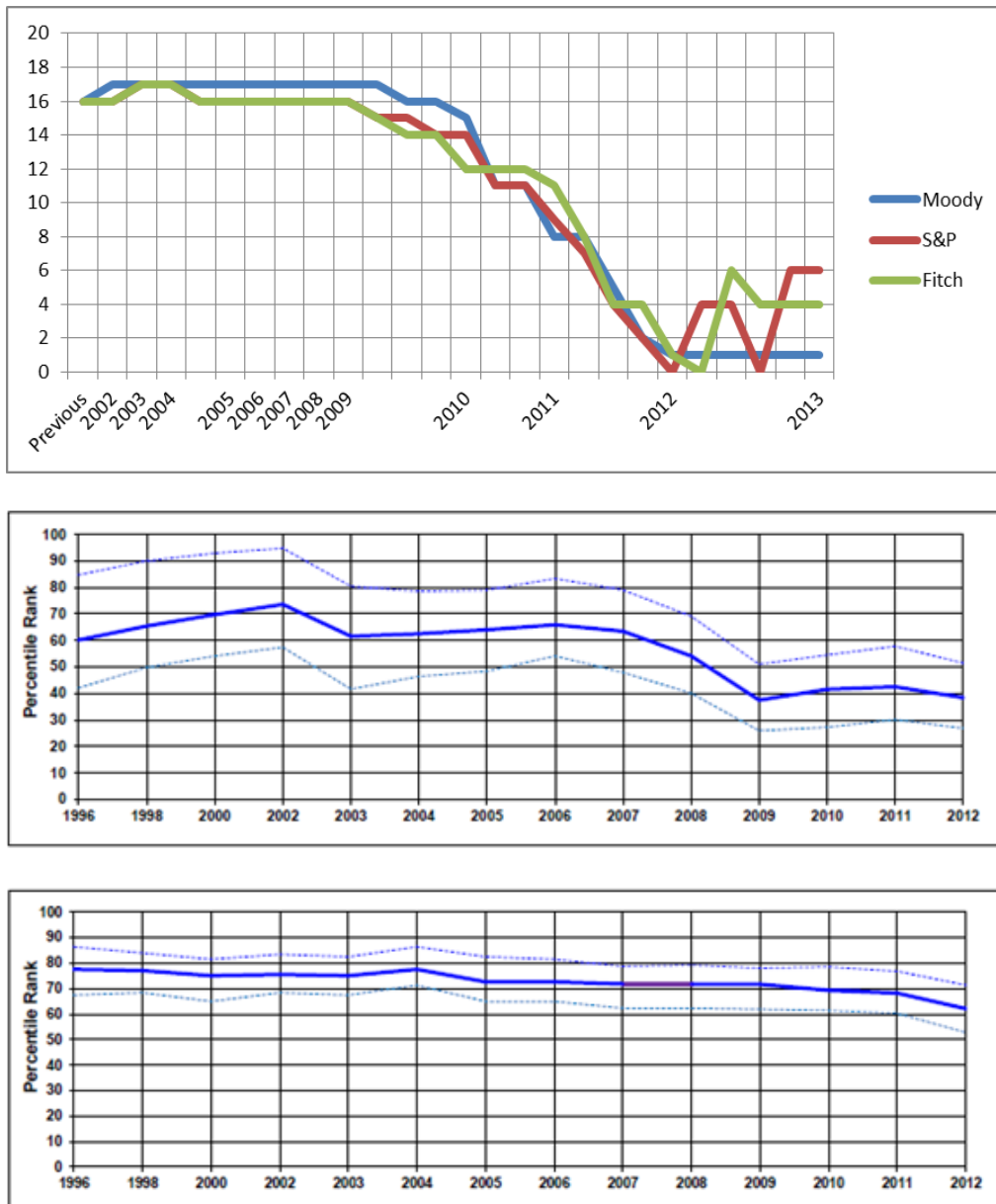


Figure 7: Greece sovereign credit ratings and World Bank WGI indicators (political stability and absence of violence, and government effectiveness) 1996 – 2012.

The crisis in Greece resulted from many factors; massive state loans, the state not gaining enough revenue (partly due to a dysfunctional tax assessment and collection process), inflexible institutions slowing reforms and one of the most expensive pension systems in Europe. Weak financial institutions affected the implementation of adopted austerity measures, which in turn had a negative effect on the ratings. Although the financial crisis was the main factor behind the downgrade of Greece’s rating, the government’s dealing with the crisis and the international community’s reaction to this also influenced the rating. A demonstrated willingness from the government to reform the financial system had a positive effect on the rating, while a history of inability to introduce reforms did effect the rating negatively. The government’s continuing efforts to

reform despite pressure from the civilian population, in the form of protests and violence, did again have a positive effect on the rating. It can be observed how predictability in politics in general affects CRA-rating positively, while uncertainty ahead of national elections affects the rating negatively, in particular when there is doubt about a future new government's commitment to European cooperation.<sup>41</sup>

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41 See e.g. "[www.fitchratings.com/creditdesk/press\\_releases/detail.cfm?pr\\_id=674021](http://www.fitchratings.com/creditdesk/press_releases/detail.cfm?pr_id=674021)".

"Despite episodes of civil unrest, Fitch judges that the political commitment to the ambitious fiscal consolidation and structural reform programme agreed with the EU and IMF remains very strong and that the path to sustainable economic recovery and solvency is achievable. The outcome of the local elections strengthened the government's mandate in support of the EU-IMF programme and despite the discussions surrounding the 'European Stability Mechanism' and 'burden-sharing' by private creditors, Fitch continues to believe that the IMF and EU remain fully committed to the success of the programme agreed with the Greek authorities." "[www.fitchratings.com/creditdesk/press\\_releases/detail.cfm?pr\\_id=712341](http://www.fitchratings.com/creditdesk/press_releases/detail.cfm?pr_id=712341)". "The rating downgrade reflects the scale of the challenge facing Greece in implementing a radical fiscal and structural reform programme necessary to secure solvency of the state and the foundations for sustained economic recovery.

"[www.fitchratings.com/creditdesk/press\\_releases/detail.cfm?pr\\_id=745069](http://www.fitchratings.com/creditdesk/press_releases/detail.cfm?pr_id=745069)". "in the near term, the prospect of a general election and uncertainty over the composition and commitment of a new government to the EU-IMF programme also poses a significant risk." "[www.fitchratings.com/creditdesk/press\\_releases/detail.cfm?pr\\_id=750064](http://www.fitchratings.com/creditdesk/press_releases/detail.cfm?pr_id=750064)". "The downgrade of Greece's sovereign ratings reflects the heightened risk that Greece may not be able to sustain its membership of Economic and Monetary Union (EMU). The strong showing of 'anti-austerity' parties in the 6 May parliamentary elections and subsequent failure to form a government underscores the lack of public and political support for the EU-IMF EUR173bn programme." The Greek financial crisis also affected Cyprus deeply and was a contributing factor of the fast decline of the latter country's economy. The reasons for the decline do seem to be mainly financial, stemming also from the financial crisis in Greece, but how the government handled the financial crisis was the main political factor affecting Cyprus' rating. The timely and efficient implementation of rescue packages had a positive effect on the rating, or at least contributed to the ratings not being lowered further. See e.g. "[www.standardandpoors.com/prot/ratings/articles/en/us/?articleType=HTML&assetID=1245360860846](http://www.standardandpoors.com/prot/ratings/articles/en/us/?articleType=HTML&assetID=1245360860846)". "The upgrade reflects our view that the immediate risks to Cyprus' program implementation, and, therefore, to full and timely payment of debt service, appear to have receded."

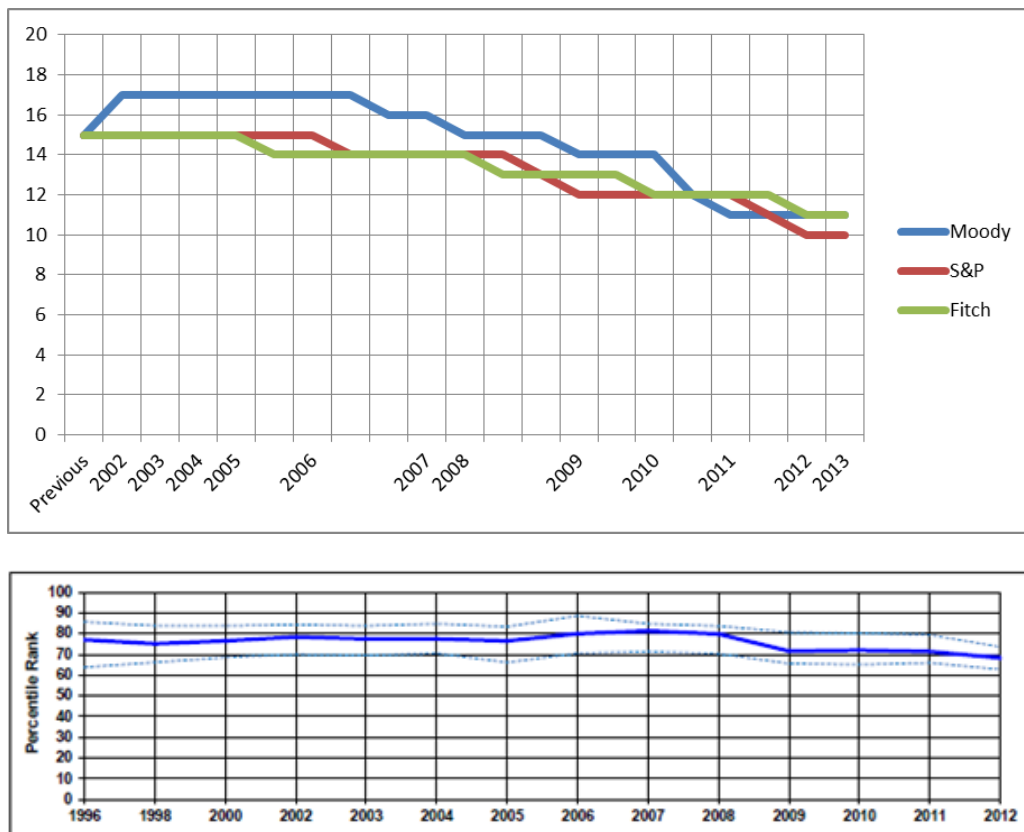


Figure 8: Hungary sovereign credit ratings and World Bank WGI indicators (rule of law) 1996 – 2012.

During recent years Hungary has implemented substantial changes to its constitution and laws with little regard to the EU conception of the rule of law. The WGI notes this by lowering Hungary 10 points in its percentile rank for rule of law compliance, while the changes in the constitution and important laws concerning the central bank, the constitutional court and the media were considered unorthodox and hindering predictability, and have had a direct impact on Hungary's rating, which to some extent has been alleviated by confidence in the relevant external control mechanisms, notably Hungary's EU membership.

The constitutional changes gained massive criticism from individual Member States, but no particular measures from the EU as such. In December 2011 the parliament reformed the law relating to the Hungarian National Bank in order to increase cabinet control. This was a contributing factor behind both Standard and Poor's and Fitch's downgrades of the Hungarian rating in 2012. The reforms of the Hungarian National Bank and later the constitutional court were considered to weaken the institutional strength of Hungary, which affected the rating negatively. While the economic crisis was the main contributing reason for the downgrades of Hungary's rating prior to 2011, the increased dominance of the *Fidesz* political party from 2010 brought political issues to the front in the rating context.

It can generally be said that external factors tying the hands of states to some extent have a positive impact on a country's rating, as it reduces uncertainty and unpredictability in governance. Membership in the EU, EMU and to some extent NATO increases the predictability of the countries' conduct as the conditions of membership are to various degrees controlled by the respective forms of cooperation. Membership appears also to be seen as a guarantee for a minimum level of e.g. institutional strength and efficiency, and as a strong incentive for countries not to act without respecting fundamental principles such as rule of law. External control also reduces the scope for drastic or populist reform based on political preferences contrary to membership obligations, of which Hungary can be seen as an example. The changes in the constitution, in the important laws concerning the central bank, the constitutional court and the media that have occurred in Hungary in recent years have been considered unorthodox and hindering predictability. The changes have had a direct impact on Hungary's rating, which to some extent has been alleviated by confidence in the relevant external control mechanisms, notably Hungary's EU membership. Whether the CRAs will remain confident about the external control that can be exercised over Hungary, for instance through use of the Article 7 TEU-procedure remains to be seen. In fact, the market has already punished Hungary harder for its failure to respect Article 2 TEU than the EU itself, in its reluctance to activate the Article 7 mechanisms.<sup>42</sup>

A parallel assessment development that may have had impact on EU leverage especially during the final years of the accession process, is the fact that with a few exceptions, most Candidate Countries had been rewarded by the market for their reforms already back in the late 1990s. In these instances, the country in question was given a significant market reward for moving in the direction also required by it from the EU prior to membership. Bulgaria and Romania are exceptions to this finding, not even approaching investment grade ratings until 2004, something that Lithuania achieved already in 2001. With the exceptions of Bulgaria and Romania, the leverage of the EU and the market was probably minimal between 2002 and 2004; the financial rewards had already been received, and the political reward – membership – had also been granted.<sup>43</sup>

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42 See e.g. “[www.bloomberg.com/news/2011-12-21/hungary-downgraded-to-bb-by-s-p.htm](http://www.bloomberg.com/news/2011-12-21/hungary-downgraded-to-bb-by-s-p.htm)” “Hungarian Prime Minister Viktor Orban's drive to consolidate power at the cost of delaying an International Monetary Fund bailout prompted Standard and Poor's to become the second ratings company in a month to downgrade the country's debt to junk.” “[www.fitchratings.com/creditdesk/press\\_releases/detail.cfm?pr\\_id=738481](http://www.fitchratings.com/creditdesk/press_releases/detail.cfm?pr_id=738481)”. “Additional unorthodox policy measures have further undermined confidence in policy making.”

43 Slovakia remained just below that grade for the same years as the Commission exposed the country to the full leverage of accession conditionality, and its full re-entry into the negotiation process coincides with a meeting on 22 December 1998 of the ratings committee of Fitch, that raised the rating one notch of Slovakia. Slovakia is the only country that was seriously exposed to negative EU leverage during its accession negotiations. The EU was not the only entity reacting to its shortcomings, as is clearly shown by Slovakia's ratings in the Freedom in the World-index. Between 1993 and 1994 Slovakia took the important step from being rated as a “Partially Free” country to a “Free” country, its two scores having moved from 3 and 4 in 1993 to 2 and 3 in 1994. For 1996

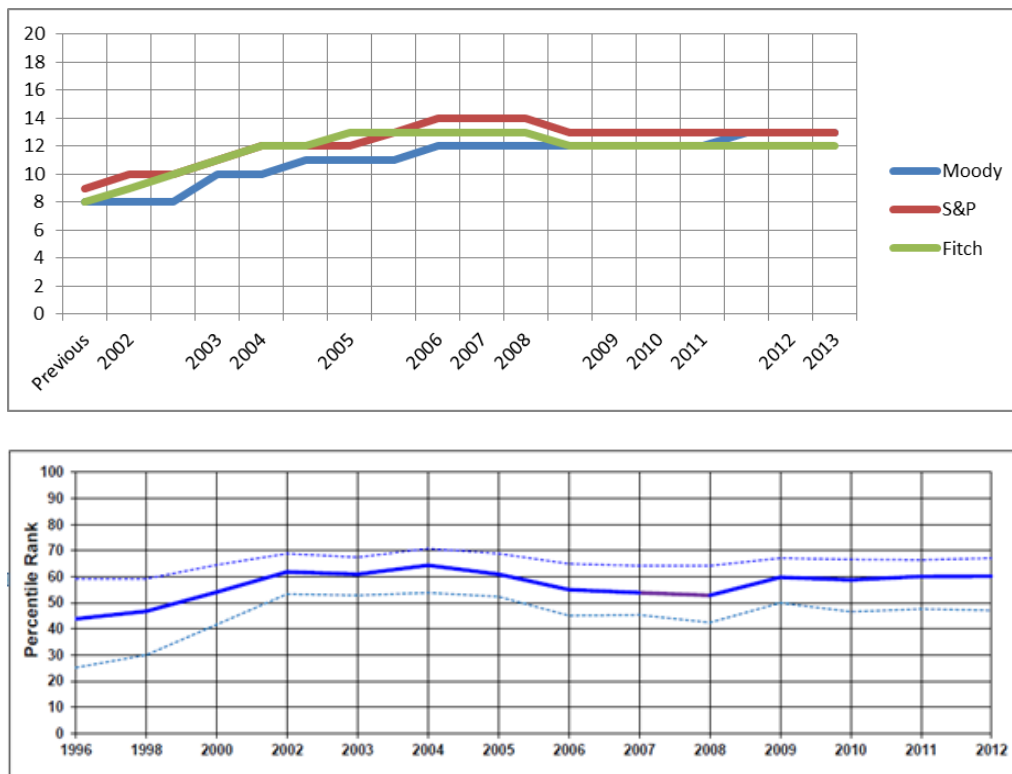


Figure 9: Bulgaria sovereign credit ratings and World Bank WGI indicators (government effectiveness) 1996 – 2012.

The development between 2002 and 2007 corresponds with Bulgaria's efforts to develop its economy, and its rule of law compliance ahead of joining the EU in 2007. The downgrade from 2008 coincides with the financial crisis, but also with the EU-Commission freezing subsidies to Bulgaria due to its inability to deal with corruption and organized crime. When Moody upgraded Bulgaria in 2011, it explicitly stated that the EU-driven reform of the justice system and the police had had an impact on the rating.<sup>44</sup>

Romania has been heavily criticized for persistent high levels of corruption and lack of institutional strength. Institutional and financial reforms in anticipation of entry into the EU were the predominant reasons for the upgrades of Romania's ratings. The EU membership provided a framework for improvements and functioned as an incentive for the government to reform its institutions. According to Fitch, the membership worked as an incentive for reform beyond EU entry. EU demands after Romania had joined also did affect the rating positively as it provided incentives for further reforms, while internal

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and 1997 it slips back into the "Partially Free" category, as a result of the same government actions that made the EU issue a scolding assessment in the 1997 progress report on accession preparations. From 1998 Slovakia was welcomed back into the negotiations, and into the circle of "Free" countries, where it has remained since.

44 See i.a. "[www.bloomberg.com/apps/news?pid=newsarchive&sid=a\\_aCavgBHQFI](http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a_aCavgBHQFI)", "[www.moodys.com/research/Moodys-upgrades-Bulgarias-government-ratings-to-Baa2stable-from-Baa3?lang=en&cy=global&docid=PR\\_223136](http://www.moodys.com/research/Moodys-upgrades-Bulgarias-government-ratings-to-Baa2stable-from-Baa3?lang=en&cy=global&docid=PR_223136)".

political difficulties affected the rating negatively, as did institutional weaknesses and corruption.<sup>45</sup>

There is a period of adaptation of this group of countries (former Communist Candidate Countries), not only to EU criteria, but as a normal course of development following the economic mismanagement during their authoritarian past. There is also a clearly discernable correlation between the progress made with regard to EU-criteria in the area of rule of law, and the positive reactions of CRAs to developments in these countries during the same period of time. Improved rating as a result of imminent EU-membership is an experience of all new EU Member States prior to their entry, except where the rating was already at a high level, as for instance in the case of Malta and Cyprus, whose rating were not changed at the time of entry, but were at a high level in comparison to the other countries that joined at the same time.<sup>46</sup> The motivations for the increases in rating point to reforms – economic, political and institutional – ahead of EU membership as the dominant factor for the higher ratings. Even after EU-entry the membership remains a positive factor that supports a high rating or is given as a reason for not lowering the rating additionally. The closer the point of membership we move along the timeline, the less significant the market rewards become, suggesting that the country is moving towards a level of normalization of market relations at a higher level than before the development started. From that point of relative equilibrium, the positive rewards appear to thin out, and the CRA ratings revert to punishing negative developments instead, as was already the case with countries already on the inside of the EU.

There are generally four factors that have played important roles in the changes in sovereign rating: EU membership, Eurozone-entry, the financial crisis in 2008 and the crisis in the Eurozone in 2011. The financial crisis was the single largest factor affecting the credit ratings in the EU in recent years. Political inability to deal with the financial crisis – as for instance in Slovenia and Malta – had a direct impact on how the rating changed during the financial crisis. In Slovenia's case its government was considered to have had a lax attitude towards reform and did not act in a timely manner in response to the crisis. The UK was also considered to have acted in a manner not necessarily sufficient to help the country out of the crisis, and had its rating downgraded. In Ireland's case, however, the government's handling of the financial crisis did lead to its rating not being downgraded further than it was. Ireland's strong commitment to fiscal consolidation and structural reforms, its transparency in handling of the crisis, a history of political cohesion and commitment at earlier

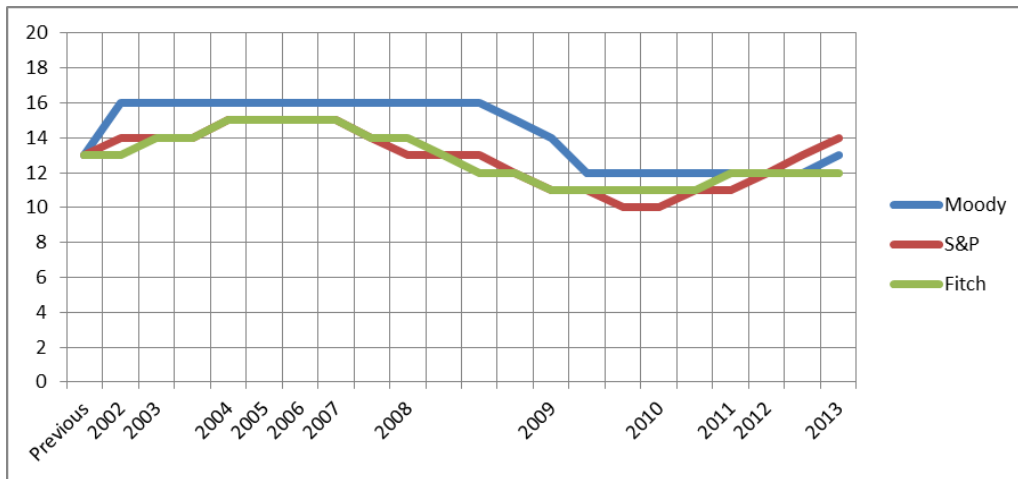
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45 See i.a. “[www.moodys.com/research/MOODYS-RAISES-ROMANIAS-RATINGS-AS-POLICIES-REFLECT-EU-INTEGRATION--PR\\_93661](http://www.moodys.com/research/MOODYS-RAISES-ROMANIAS-RATINGS-AS-POLICIES-REFLECT-EU-INTEGRATION--PR_93661)”. “Moody's Investors Service has upgraded Romania's country ceiling for foreign currency bonds to Ba1 from Ba3 as the country continues to benefit from policies that conform to prospective membership in the European Union (EU).” “[www.moodys.com/research/Moodys-upgrades-Romanias-ratings-to-Baa3--PR\\_120791](http://www.moodys.com/research/Moodys-upgrades-Romanias-ratings-to-Baa3--PR_120791)”. “[www.fitchratings.com/creditdesk/press\\_releases/detail.cfm?pr\\_id=447839](http://www.fitchratings.com/creditdesk/press_releases/detail.cfm?pr_id=447839)”, “[www.fitchratings.com/creditdesk/press\\_releases/detail.cfm?pr\\_id=720622](http://www.fitchratings.com/creditdesk/press_releases/detail.cfm?pr_id=720622)”.

46 See i.a. “[www.moodys.com/research/Moodys-upgrades-Cyprus-and-Malta-following-entry-to-Eurozone--PR\\_147152](http://www.moodys.com/research/Moodys-upgrades-Cyprus-and-Malta-following-entry-to-Eurozone--PR_147152)”.

setbacks and its determination in response to the financial crisis were considered positive.<sup>47</sup>

A particular feature that should be mentioned here is the stand-alone effect of Eurozone membership. There is a positive ratings-effect of Eurozone membership for the countries that are admitted after the launch of the common currency. In particular Latvia benefited from Eurozone membership during the years immediately before its entry in January 2014. According to Fitch the Eurozone works as “a key policy disciplining tool” to steer and limit a government’s discretionary actions. The CRAs in general considered the EMU-cooperation to serve as a guarantee for needed improvements relating to the rule of law to take place in Latvia, for instance by reducing corruption, strengthening political institutions and streamlining policy-making, which affected the rating positively.<sup>48</sup>



47 See i.a. “[www.moody.com/research/Moodys-downgrades-Ireland-to-Aa1-outlook-negative--PR\\_182430](http://www.moody.com/research/Moodys-downgrades-Ireland-to-Aa1-outlook-negative--PR_182430)”, “[www.fitchratings.com/creditdesk/press\\_releases/detail.cfm?pr\\_id=528356](http://www.fitchratings.com/creditdesk/press_releases/detail.cfm?pr_id=528356)”, “[www.moody.com/research/Moodys-downgrades-Ireland-to-Aa2-stable-outlook--PR\\_202662](http://www.moody.com/research/Moodys-downgrades-Ireland-to-Aa2-stable-outlook--PR_202662)”, “[www.standardandpoors.com/ratings/articles/en/us/?assetID=1245220032861](http://www.standardandpoors.com/ratings/articles/en/us/?assetID=1245220032861)”, “[www.fitchratings.com/creditdesk/press\\_releases/detail.cfm?pr\\_id=631262](http://www.fitchratings.com/creditdesk/press_releases/detail.cfm?pr_id=631262)”, “[www.moody.com/research/Moodys-downgrades-Ireland-to-Baa1-from-Aa2-outlook-negative--PR\\_211361](http://www.moody.com/research/Moodys-downgrades-Ireland-to-Baa1-from-Aa2-outlook-negative--PR_211361)”, “[www.fitchratings.com/creditdesk/press\\_releases/detail.cfm?pr\\_id=660581](http://www.fitchratings.com/creditdesk/press_releases/detail.cfm?pr_id=660581)”, “[www.standardandpoors.com/prot/ratings/articles/en/us/?assetID=1245288510820](http://www.standardandpoors.com/prot/ratings/articles/en/us/?assetID=1245288510820)”, “[www.standardandpoors.com/ratings/articles/en/us/?assetID=1245301741237](http://www.standardandpoors.com/ratings/articles/en/us/?assetID=1245301741237)”, “[www.moody.com/research/Moodys-downgrades-Ireland-to-Baa3-from-Baa1-outlook-remains-negative--PR\\_217494](http://www.moody.com/research/Moodys-downgrades-Ireland-to-Baa3-from-Baa1-outlook-remains-negative--PR_217494)”, “[www.moody.com/research/Moodys-downgrades-Ireland-to-Baa1-outlook-remains-negative--PR\\_222257](http://www.moody.com/research/Moodys-downgrades-Ireland-to-Baa1-outlook-remains-negative--PR_222257)”.

48 See i.a. “[www.fitchratings.com/creditdesk/press\\_releases/detail.cfm?pr\\_id=89033](http://www.fitchratings.com/creditdesk/press_releases/detail.cfm?pr_id=89033)”. “The rating upgrade reflects continuing structural reforms, partly driven by accession to the EU in 2004...” “[www.fitchratings.com/creditdesk/press\\_releases/detail.cfm?pr\\_id=175231](http://www.fitchratings.com/creditdesk/press_releases/detail.cfm?pr_id=175231)”, “[www.fitchratings.com/creditdesk/press\\_releases/detail.cfm?pr\\_id=408836](http://www.fitchratings.com/creditdesk/press_releases/detail.cfm?pr_id=408836)”. “Wider support to creditworthiness derives from institutional strengths of an EU member state and underlying political stability.”



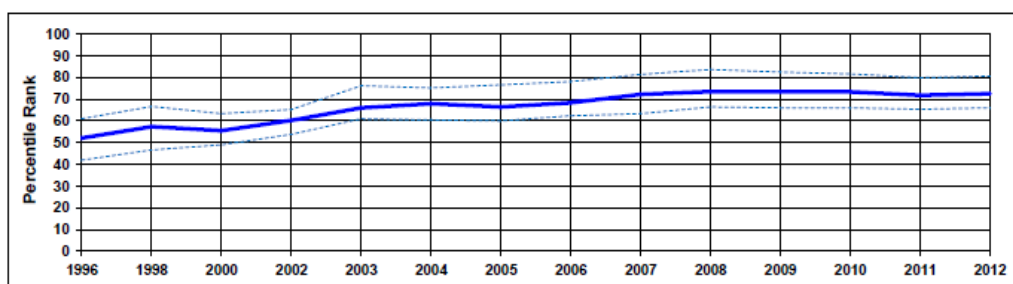


Figure 10: Latvia sovereign credit ratings and World Bank WGI indicators (rule of law) 1996 – 2012.

Latvia has made steady increases on WGI rule of law measuring since it started to negotiate EU membership, and on into its membership. The EU supported this development up until Latvia joined in 2004, and then again as Latvia prepared for Eurozone membership leading up to this year. The CRAs considered the EMU-cooperation to serve as a guarantee for needed improvements relating to the rule of law to take place in Latvia, for instance by reducing corruption, strengthening political institutions and streamlining policy-making, which affected the rating positively.

The accomplishment of requirements for Latvia to be included in the Eurozone did affect Latvia's rating positively as it demonstrated efficiency in its policy making. The EU membership did also affect the rating positively as it demonstrated Latvia's political and institutional strengths. The membership did however not affect Latvia's rating at the time of its entry in 2004, as Latvia's rating was already high compared to other states joining the EU at the same time. Public unrest resulting in the government resigning in 2009, as well as the IMF package hence being delayed contributed to an increased uncertainty in the political climate, which effected the rating negatively. An exhibited strong political and social will to keep to the austerity measures in the IMF program, which was shown by the government being reelected in October 2010, affected the rating positively. Improvements relating to rule of law, reducing corruption, strengthening of political institutions, making policy making more efficient, making voting in parliament more transparent, introducing state funding to political parties as well as limiting political advertising, strengthened political accountability and furthered the political climate, all changes that affected the rating positively, as they limited the space for government discretion.<sup>49</sup>

49 See i.a. "[www.moodys.com/research/Moodys-downgrades-Latvias-rating-to-A3-from-A2--PR\\_166830](http://www.moodys.com/research/Moodys-downgrades-Latvias-rating-to-A3-from-A2--PR_166830)". "[www.moodys.com/research/Moodys-downgrades-Latvia-to-Baa1-outlook-remains-negative--PR\\_170357](http://www.moodys.com/research/Moodys-downgrades-Latvia-to-Baa1-outlook-remains-negative--PR_170357)". "[www.moodys.com/research/Moodys-downgrades-Latvia-to-Baa3-outlook-remains-negative--PR\\_177246](http://www.moodys.com/research/Moodys-downgrades-Latvia-to-Baa3-outlook-remains-negative--PR_177246)". "[www.fitchratings.com/creditdesk/press\\_releases/detail.cfm?pr\\_id=467419](http://www.fitchratings.com/creditdesk/press_releases/detail.cfm?pr_id=467419)". "[www.fitchratings.com/creditdesk/press\\_releases/detail.cfm?pr\\_id=693001](http://www.fitchratings.com/creditdesk/press_releases/detail.cfm?pr_id=693001)". "[www.moodys.com/research/Moodys-upgrades-Latvias-government-bond-rating-to-Baa2-outlook-positive--PR\\_268182](http://www.moodys.com/research/Moodys-upgrades-Latvias-government-bond-rating-to-Baa2-outlook-positive--PR_268182)".

## 4 Conclusions

By comparing these different groups of assessments and their consequences, it is possible to discern when reactions to performance coincide between the groups of actors, which is where we find rule of law developments that attract the attention of non-rule of law actors, either for rewards or punishment by the market forces.

Many lessons will be learned from the financial crises starting in 2008 and the instances of Member State violation of Treaty-enshrined values over the past decade. One lesson for the EU is no doubt that any goal stated in its constitutional treaties that is not backed up with a genuine sanction, is destined to be poorly implemented, if at all. The EMU lacked viable sanctions in the treaties and instead has relied on the Stability Pact between the Eurozone countries, a pact that was frequently being breached, to no direct consequence for those in breach.<sup>50</sup> The Article 7 TEU-procedure is likewise unused due to its deterring structure and lack of political will, while the enlargement mechanisms actually are changing state structure and behavior along EU values. As long as rule of law-principles are perceived to be matters within the justice sector, they are unlikely to be able to mobilize the strength of the whole of any government, including its finance ministry.

This asymmetry of internal and external enforcement is being demonstrated continuously through the non-sanctioning of Treaty breaches. But what Figure 3 also shows, is that when instances of converging “power projection” converge on common features, such as the rule of law in general or the fight against corruption, this offers an opportunity for designing strategies for reform, incorporating rule of law market cognition and a chance to piggy-back on the projection powers of other forces.

The strength of the EU is most clearly demonstrated in the enlargement processes, past and present, while a weakness is demonstrated by its incapacity of enforcing its values on states that have been admitted into it. It is somewhat ironic that upon completion of the enlargement of the past decade, one of the leading sources for economic data and ratings, the Economist Intelligence Unit (EIU), published its well-respected *Democracy index for 2007*.<sup>51</sup> The following countries were rated as “flawed democracies”: Estonia, Italy, Cyprus, Hungary, Lithuania, Slovakia, Latvia, Poland, Bulgaria, and Romania. The only countries in that group for which the underlying problems could even be marginally raised by EU efforts, were Bulgaria and Romania, as their respective accession agreements contain monitoring mechanisms that stretch into the first three years of EU membership. With the other member states, new and old, there is no mechanism, short of the sanctions in article 7 TEU and the *in casu*-powers of the Court, to ensure any corrective action from the EU as such.

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50 The procedure in Article 122 TFEU is just like Article 7 drafted in a way designed to discourage its use.

51 See *The World in 2007*, The Economist Intelligence Unit’s index of democracy, pp. 3-4.

	<b>EU-leverage</b>	<b>Rule of Law-Ratings leverage</b>	<b>CRA-ratings leverage</b>
<b>Member States</b>	Practically none, save for extreme Article 7-situations	Only to the extent they affect CRA-ratings	Yes, as incentive for status quo
<b>Candidate Countries</b>	Incentive of membership; once positive trend is established and date of accession approaches, leverage ceases	Yes, primarily insofar as they affect EU- and CRA-ratings	In early days of enlargement negotiations positive effects are “cashed in” by CRAs, but EU membership is likely to be prime motivator; later in process: yes, as incentive for status quo

Figure 11: Comparison of leverage between the three different types of assessments: EU-compliance, rule of law-ratings (e.g. World Bank, etc.), and CRA-ratings.

During the accession process the efforts of the EU to promote the rule of law in a Candidate Country coincides with positive reactions from the market for the same development. The Candidate Country is rewarded twice for its efforts. Any rule of law activities in a Candidate Country during this phase of dual influence should subsequently be able to piggy-back on the EU and market forces.

During membership, however, a Member State is no longer rewarded by the EU for its rule of law efforts, except when making the additional efforts required to enter the Eurozone. The reactions during the membership phase are more significant for negative developments, although not from the EU itself, except in individual EU Court cases. The EU does not use its coercive powers to halt a negative trend, except when using the mechanisms put in place for Bulgaria, Romania and potentially in Croatia.

The market, however, does react negatively to declining levels of rule of law compliance, regardless of membership status. Therefore rule of law activities that can somehow be seen as a response to negative market reactions are likely to attract the attention not only of the justice sector but also the financial sector, with its broader influence.

The EU is at its most effective and powerful in projecting its values in countries on its outside, at a certain span of time within a negotiation for EU membership. That point is clearly before a political decision has been taken on admitting the country per a certain date or even year. Once that decision is a fact, all conditionality vanishes and no bridging arrangements can truly replace

the *ex ante* conditionality. The incentives could be expected to enhance the influence of the EU – financing reforms in the areas of society where a state is underperforming and using accession-conditionality for reform in the same area ought to be a more powerful combined projection effort than either effort taken on its own. Concerning the coercive enlargement-effects, there appears to be a peak during the negotiation process, after which the impact of conditionality withers away. Incentives or positive conditionality suggests that some form of reward, e.g. economic assistance or preferential trade treatment, is linked to requirements concerning the recipient country's respect for e.g. human rights, democracy and the rule of law. Negative conditionality or coercion implies that the withdrawal of benefits or other sanctions may hit a party in breach of the agreed requirements. In order to promote specific values, these measures, positive and negative, need to follow a conscious timeline for promotion, where quantifiable targets are established. Although the EU is seen as the main proponent of soft power internationally, it appears that the powers of the EU domestically are equally soft in areas where it really matters. For Member States underperforming, the EU has nothing tangible to wield except in relation to upholding the *acquis*. Where there are goals and values to which no viable mechanisms in primary EU law are attached, we do not even have effective soft law mechanisms to ensure coherence within the system, although this could change with the recent Commission framework.<sup>52</sup>

Using assessment-data from the different spheres has an additional advantage. The “normal” consumers of assessment data and especially CRA-data in any government are likely to be found in the ministries of finance. In most national administrations it is also the ministry of finance that will ultimately have strong influence over what the reasonable levels of reform ambitions of other ministries may be. When ministries of finance are not engaged early on in rule of law reform, any undertaking is prone to become victim of the scarcity of resources. In countries emerging from various forms of authoritarian rule, the ministries of defense and interior normally represent policy areas with some clout *vis-à-vis* finance, whereas justice ministries for obvious reasons dwell in the neglected area that needs reinforcing, in a zero-sum game: at the expense of other policy areas. It is worth considering what proposals could reinforce sovereign ratings – i.e. are there particular projects or project outcomes that could affect ratings positively? – as this widens the potential “constituency” for rule of law reform.<sup>53</sup>

The purposes of the projection of the rule of law vision of the EU differs significantly from the reasons for which other actors project their vision. Especially when we look at EU enlargement: there is an end-state in sight, a binary threshold and once a country has passed it the operational purpose for the projection ceases. For other rule of law actors the reasons for projecting their visions, to the extent that they do, will be relative rather than absolute. A

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52 See COM(2014) 158 final.

53 See Wennerström, E., *Complementarity, Local Ownership and Justice Sector Assistance in Future Legal and Justice Strategies*, in *Law and Justice: A Strategy Perspective*, Muller, S., and Zouridis, S. (eds.), Torkel Opsahl Academic EPublisher, The Hague 2012.

system needs improvement and the measures through which the vision is projected are intended to assist the country in that direction, but there is no end-state of definitive character, such as passing into another category of states or attaining membership in the organization of the rule of law actor. For the market actors active in rule of law, there is definitely no end-state in sight, not even an organizational goal as regards the development in the country in question – the market will react to developments, it will punish the negative developments and reward the positive, but it will leave the failures on their own and seek out the profitable markets, and that is the whole business plan. To establish whether an actor has to some extent been successful in projecting its vision of rule of law or exercised its influence without a specific vision of rule of law needs to be assessed with a specific timeframe in mind, thereby relativizing the “success rate”.



# **Beyond Law and Development**

